March 31, 2007

"Bezeq" The Israel Telecommunication Corp. Limited

Annual Report for 2006*

Chapter A - Description of Company Operations

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

Chapter C - Financial Statements

Chapter D - Additional Details About the Corporation

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

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

Chapter A – Description of Company Operations

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

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Chapter A - Description of Company Operations

In this report, which contains a description of the Group's business operations as at December 31, 2006, the Group included forward-looking information, as defined in the Securities Law 5728-1968 (hereinafter: the "**Securities Law**") with respect to both itself and the market. Such information includes forecasts, targets, appraisals and assessments which apply to future events or matters the realization of which is not certain and is not under the Group's control. Forward-looking information in this report will usually be identified specifically, or by employing statements such as "the Company expects", "the Company assesses", "it is the Company's intention", and similar statements.

Forward-looking information is not a proven fact and is based only on the Group's subjective assessment, based, inter alia, on a general analysis of the information available at the time of drafting of this report, including public announcements, studies and surveys, and they contain no undertakings as to the correctness or completeness of the information contained therein, and the Group does not independently check the correctness thereof.

In addition, the realization and/or otherwise of the forward-looking information will be affected by factors that cannot be assessed in advance, and which are not within the control of the Group, including the risk factors that are characteristic of its operations as set out in this report, and developments in the general environment, and external factors and the regulation that affects the Group's operations, as set out in this report.

1. Description of General Development of Group Operations

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

In its financial statements for 2006, the Company and its subsidiaries are reporting for the first time in accordance with international financial reporting standards (IFRS). The date for transition to IFRS was prescribed for January 1, 2005, and as a result, the Company has presented its financial statements for 2005 once again, these having been reported in the past in accordance with the accounting rules employed in Israel. In this regard, see Note 33 to the Company's financial statements for the period ended December 31, 2006, which are included in this periodic report.

1.1 Group Activity and Description of its Business Development

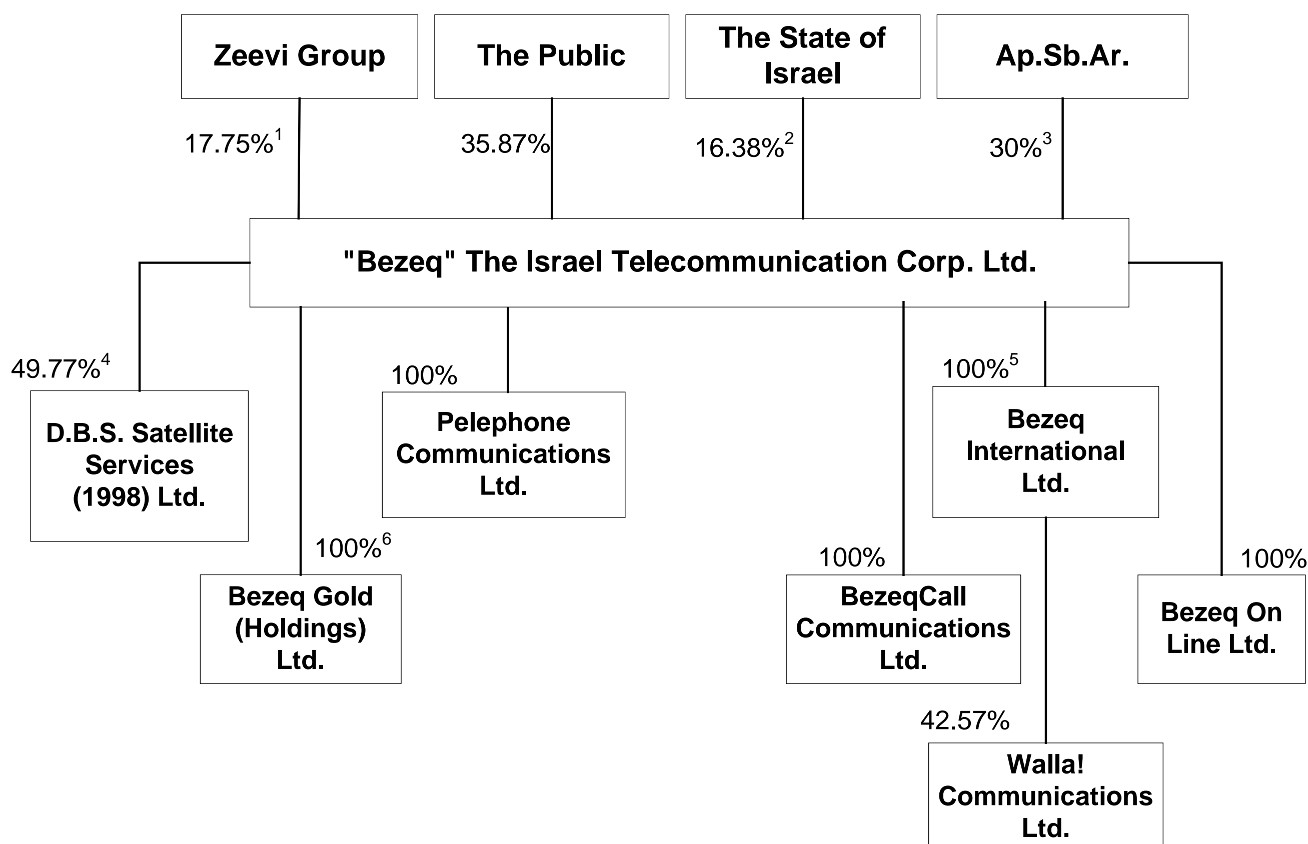
1.1.1 As of the date of this periodic report, The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international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

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

1.1.3 The Company was founded as a government company in 1980 and has been privatized over a period of years. The Company is a public company, the shares in which are traded on the Tel Aviv Stock Exchange.

1.1.4 As of October 11, 2005, the holder of control of the Company is Ap. Sab. Ar. Holdings Ltd. ("**Ap. Sab. Ar.**") which holds 30% of the shares in the Company, as well as an option to purchase up to 10.66% of the shares in the Company that are held by the State.

The 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:



Note: The Company's holdings are correct as at the date of publication of this periodic report. As noted in section 2.9.6 below, the Company issued 78,151,368 options to employees (with the exception of members of senior management), convertible into 78,151,368 shares of the Company, as part of an employee option scheme[8]. The rate of holdings of the Company under full dilution, presuming exercise of all of the options under the above scheme, is as follows:

Ap. Sab. Ar - 29.13%
The State of Israel - 15.91%
The Zeevi Group - 17.23%
The public - 37.73%

1.1.5 Mergers and Acquisitions

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

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

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

[4] As of the date of publication, the Company has an option to increase its holdings in DBS to approximately 58.36% reflecting the proportional percentage of its investments, see section 1.1.5 (A).

[5] The operations of the Goldnet Communications Services partnership have been transferred to Bezeq International Ltd. BezeqCall Communications Ltd. has also been merged into Bezeq International Ltd. See sections 1.1.5 and 1.1.6 below.

[6] An inactive company which holds debentures (series 5) of the Company (see section 2.13.7 and 2.17.1 below).

[7] 33.66% under full dilution.

[8] Of this sum, approximately 59,574 options will be issued to two directors from among the employees subject to and following the approval of the general meeting of the shareholders of the Company, which is expected to be held on April 15, 2007.

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

On January 2, 2005, the Antitrust Commissioner conditionally approved the merger between the Company and DBS (increase of the Company's holdings in DBS to more than 50%). The merger did not take place within a year of the date of approval of the merger, and required a new consent. On August 2, 2006, the Company and DBS submitted new merger notices to the Antitrust Commissioner (the "**Commissioner**") regarding the exercise of options for DBS's shares by the Company, which are expected to increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Commission gave notice of the Antitrust Commissioner's objection to the merger and on February 18, 2007, the grounds for such objection were given. The Company intends to file an appeal against this decision.

In this regard, see also Note 32 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

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

At the end of July 2006, proceedings were initiated for merger of the operations of the subsidiary BezeCall Communications Ltd. (network end point operations) and the subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for business), so that the operations of BezeqCall would transfer to Bezeq International. On October 5, 2006 the merger was approved by the Antitrust Commissioner. On December 31, 2006 the Ministry of Communications gave its approval for assign of BezeqCall's network end point license to Bezeq International, and the merger became final on February 11, 2007.

C. Acquisition of Tadiran-Telecom

On October 15, 2006, BezeqCall Communications (before the merger with Bezeq International) signed an agreement to acquire all the operations of Tadiran-Telecom – Israel Communication Services, a limited partnership, in consideration of NIS 93 million (subject to certain adjustments depending on the date of closing the transaction). The closing was subject to the completion of a due diligence process and to the receipt of approvals, including from the Antitrust Commissioner. On March 27, 2007, the Company was informed that the Antitrust Commissioner did not approve of the transaction. Bezeq International Ltd. and Tadiran Telecom are considering their steps in this regard.

1.1.6 Disposals

Satellite Communications Operations

The Company terminated contacts with potential buyers for its satellite communication operations (Inmarsat and Bezeq Sat), and is assessing its further activity in this field.

Walla! Communications Ltd.

Further to immediate reports of the Company on April 10, 2006 and June 22, 2006, concerning examination of the holdings in Walla! Communications Ltd. through the subsidiary Bezeq International Ltd., the Company announced, in an immediate report on July 19, 2006, that it has terminated the contacts it had made on this subject.

Goldnet Communication Services ("Goldnet")

On April 30, 2006, an agreement was signed between the Company, Malam Systems Ltd. and Goldnet, a limited partnership, of the first part, and the subsidiary Bezeq International of the other part, concerning acquisition of all the operations of Goldnet by Bezeq International in consideration of NIS 6.8 million, to be divided between the Company (NIS 5.1 million) and Malam Systems (NIS 1.7 million). The agreement has been concluded and Goldnet's operations have been transferred to Bezeq International. In this regard, see also section 4.9.2 below.

1.2 Areas of Operation

The Group has four principal areas of operation. These four areas of activity are reported as business segments in the Company's consolidated financial statements (see also Note 28 to the Company's financial statements for the year ended December 31, 2006, included in this periodic report):

1.2.1 Fixed-line domestic communications

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

1.2.2 Cellular

Cellular mobile radio-telephone services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems. This activity is performed by Pelephone Communications Ltd. (hereinafter: "**Pelephone**").

1.2.3 International communications and internet services

International communications services as well as internet access services (ISP). This activity is performed by Bezeq International Ltd. (hereinafter: "**Bezeq International**"). Bezeq International also holds 42.57% (33.66% fully diluted) of Walla! Communications Ltd., an Israeli company whose shares are registered for trading on the Tel Aviv Stock Exchange, and which deals in the provision of services in the field of internet, and in the activation of internet portals (see section 4.14 below).

1.2.4 Multi-channel television

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

Note that in the past, the Company, in its financial statements, reported an area of operations entitled "Others", which included the operations of BezeqCall Communications Ltd., which dealt in network end point services, the Goldnet Communications Services Partnership, which dealt in content services, and Bezeq On-Line, which deals in call center services. Due to the merger of the operations of BezeqCall Communications (see section 1.1.5 above) and Goldnet (see section 1.1.6 above) into Bezeq International, and due to the fact that Bezeq On-Line's operations are not substantial at the Group level, the Company will not include reference to the "others" sector in its financial statements for 2007. The 2006 report did contain reference to the "others" sector, which included the operations of BezeqCall Communications Ltd. and Bezeq On-Line Ltd. (see section 1.5 below).

1.3 Investments in Equity and Stock Transactions

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

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

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

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

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

According to information provided to the Company:

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

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

As a result of closing of the transaction, the Company was released from certain limitations that had been imposed upon it as a company under the control of the State of Israel, including repeal and/or amendment of some of the provisions of its Articles of Association which are similar to certain provisions of the Government Companies Law, 5735-1975. It is noted that on December 20, 2006, the Company replaced its Articles with new ones, in keeping with the provisions of the Companies Law and with the Company's status as a company not under State control. Prior to that replacement, the articles of the wholly owned subsidiaries of the Company have been amended such that, *inter alia*, the provisions regarding the number of members of the board of directors, proceedings for appointment of them, and provisions relating to the Government Companies Law (in the articles of former government subsidiaries) were deleted. Further to such, the directors of the Company's subsidiaries were replaced such that directors were appointed from the ranks of senior management of the Group, subject to the rules of structural separation in the Group.

1.4 Payment of dividends

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

1.4.2 Pursuant to a resolution of the board of directors dated March 1, 2006, resolutions regarding the distribution of dividends are to be passed specifically in accordance with the Company's financial results, financial state and the other relevant circumstances and data. This resolution substitutes previous resolutions regarding dividend policy.

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

Distribution date	Type of distribution	Total amount distributed (NIS)	Distributed amount per share (NIS)
16.4.2006	Cash dividend	1,200,000,193	0.4606446
30.10.2006	Cash dividend	400,000,064	0.1535482
9.1.2007	Cash dividend	300,000,179	0.1151612
26.2.2007	Cash dividend[9]	1,800,000,030	0.6909668

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

On December 28, 2006, the general meeting of the shareholders of the Company approved the recommendation of the Board of Directors of the Company to distribute a cash dividend of NIS 1,800,000,030 (amounting to NIS 0.6909668 per share), as a distribution which does not comply with the earnings test. The distrbution was subject to the approval of the court, and on December 31, 2006, the Company filed an application in court for approval of the distribution. The court approved the distribution on February 4, 2007, and the distribution was made on February 26, 2007.

[9] Distribution of a cash dividend not in accordance with the earnings test. See section 1.4.4 below.

1.4.5 It is noted that under the agreement between the State and Ap.Sb.Ar. for the sale of the controlling interest in the Company, Ap.Sb.Ar. undertook, *inter alia*, to operate by virtue of its holdings and not to make a distribution which was not from the accumulated retained earnings of the Company on December 31, 2000 (it was clarified that this would not prevent the distribution of earnings generated after December 31, 2000 in accordance with the Companies Law, 5759-1999). Ap.Sb.Ar. also undertook to operate by virtue of its holdings so that a distribution would not be made from the capital gains deriving from the realization of capital assets paid for in kind, for a period of two years from the date of purchase of the shares being sold.

1.5 Financial Information regarding the Group's Areas of Operations

1.5.1 2006:

	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	5,193,493	4,462,077	1,016,300	1,338,826	221,134	-	12,231,830
From other areas of operation in the segment	605,503	15,910	21,519	23,563	97,545	764,040-	-
Total	5,798,996	4,477,987	1,037,819	1,362,389	318,679	764,040-	12,231,830
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,687,452	3,625,410	820,458	1,209,302	324,006	-	10,666,628
Costs constituting revenues from other areas of operation	365,224	160,895	85,945	145,380	6,596	(764,040)	-
Total	5,052,676	3,786,305	906,403	1,354,682	330,602	(764,040)	10,666,628
Operating Income	746,320	691,682	131,416	7,707	(11,923)	-	1,565,202
Total identified assets as at December 31, 2006	9,756,868	3,375,001	454,918	838,793	186,391	172,230	14,784,201
Minority percentage in the segment							

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

1.5.2 <u>2005:</u>

	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	5,285,006	4,413,423	825,801	1,200,866	199,622	-	11,924,718
From other areas of operation in the segment	607,947	14,854	21,488	8,206	104,511	(757,006)	-
Total	5,892,953	4,428,277	847,289	1,209,072	304,133	(757,006)	11,924,718
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,591,737	3,660,312	670,151	1,182,920	292,662	-	10,397,782
Costs constituting revenues from other areas of operation	382,078	182,782	77,494	104,592	10,060	(757,006)	-
Total	4,973,815	3,843,094	747,645	1,287,512	302,722	(757,006)	10,397,782
Operating Income	919,138	585,183	99,644	(78,440)	1,411		1,526,936
Total identified assets as at December 31, 2005	9,638,637	3,591,679	525,114	941,693	218,100	198,372	15,113,595
Minority percentage in the segment			25.1% (**Goldnet**)				

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

1.6 General Environment and Effect of External Factors on Group Activity

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

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

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

2.1 General Information on Area of Operations

2.1.1 Area of activity and changes affecting it

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

2.1.2 Legislative and regulatory restrictions and special constraints

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

The tariffs for the Company’s main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, *inter alia*, according to recommendations of the Committee for the Regulation of Bezeq’s Tariffs. The Company’s interconnect tariffs were reduced on July 1, 2006.

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

Furthermore, some of the Company's activities involve the use of wireless frequencies and the operation of facilities emitting electromagnetic radiation, which are subject, respectively, to the Wireless Telegraph Ordinance (New Version), 5732-1972 (see section 2.16.8 below), the Pharmacists Regulations (Radioactive elements and their products), 5740-1980, and the Non-Ionized Radiation Law, 5766-2005 (see Section 2.15 below).

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

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

	2006	2005
Revenues (NIS millions)	5,799	5,893
Operating Income	753	919
Average monthly revenue per line (NIS) (ARPL)(1)	99	100
Number of active subscriber lines as at the end of the year (thousands)	2,833	2,875
Total minutes of use in Israel (outgoing and incoming) (millions)	20,528	21,499

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

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 50% of calls are made in the cellular networks. As the number of cellular subscribers has grown and reached approximately 8.5 million subscribers (according to data published by the cellular companies), there has been a decline in the number of households and businesses holding a fixed line, as well as a decline in the number of lines per customer. Furthermore, there has been an ongoing average decline in the Company's regulated and unregulated tariffs (see Section 2.16.1 below). On the development of competition in the various domestic areas, see section 2.6 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, such as voice services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

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

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

C. The increase in the number and capacity of cellular networks, along with technological enhancements, enable cellular service providers to compete with the Company's services more effectively than with existing technologies.

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

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

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

A. The ability to offer reliable communications systems at a competitive price based on a cost structure that is adjusted to the frequent changes in the Company's business environment.

B. The ability to maintain innovation and technological leadership, and to translate those into advanced, reliable applications of value to customers, within short response times.

C. Technological and marketing innovation.

D. Efficacy of internal and external sales systems and distribution channels.

E. The ability to provide high quality commercial and technical service to customers of the Company.

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

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

H. Maintaining brand values and adjusting them to the changing competitive environment.

2.1.7 <u>Main entry and exit barriers of the activity and changes affecting such</u>

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

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

2.1.8 <u>Alternatives to and changes in products of area of operations</u>

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

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

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

2.1.9 <u>Structure of competition in the areas of operation and changes therein</u>

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

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

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

In the field of telephony, Hot Telecom, a partnership of the cable companies the merger of reach was recently concluded (hereinafter: "**Hot**") commenced providing services on a commercial basis on November 25, 2004. As of September 2004, the Minister is entitled to grant special general licenses for the provision of domestic fixed-line communications services without the obligation to provide a service to everyone or to provide minimal deployment of it. Several such licenses have been granted to a number of bodies (see section 2.6.1 below). Furthermore, according to the amendment of the Communications Law in January 2005, the Minister is entitled to grant general licenses for telecommunications services or telecommunications activity and exemption by order of the licensing obligation. In November 2004, the Ministry of Communications published a policy

paper on the provision of telephony services over broadband access services (by the Company and by HOT). The policy was made subject to a hearing, and on January 31, 2007, the regulation and licensing policy for providing such services was published. With regard to this matter, see Section 2.6.1 below. The Ministry of Communications granted licenses for a "paid marketing trial" for providing these services, the validity of most of which ended a few weeks prior to the date of this Report. In this regard also, see section 2.6.1 below. Additionally, the Company views cellular telephony services as alternative services to the telephony services it provides. With regard to this matter, see Section 2.6.4 below.

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

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

2.2 Products and Services

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

2.2.2 Telephony

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

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

The Company currently operates approximately 12,000 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, but the draft was not approved by the Knesset Economics Committee, which resolved that the Ministry of Communications should submit a revised draft. To the best of the Company's knowledge, as at the date of publication of this periodic report the Ministry of Communications has not submitted an amended proposal, and in any event, no such draft has been presented to the Company.

On March 7, 2006, the Ministry of Communications announced a hearing for all the communications companies, in connection with the Ministry's intention that a joint 144 center be operated for all the companies, so that with one call, all the telephone numbers of a subscriber, with any carrier, are obtained. The service would operate in parallel with a similar service (all the numbers of all the carriers) on an internet site. In its reply written on March 26, 2006, the Company stated its position, arguing, among other things, that the information is an auxiliary service of the telephony service provided by the licensees, that entities without a general license should not be permitted to enter the sector, and that the service should be kept in its present format, as an auxiliary to the services of the general licensee. The Ministry of Communications accepted the Company's position that 144 is an auxiliary service.

On November 5, 2006, the Company license was amended so that, *inter alia*, commencing February 8, 2007, the Company is required to provide, itself or through another entity acting on its behalf, a telephone number information service of whoever is a subscriber of a

fixed-line or cellular operator, excluding unlisted numbers, for the general public and without payment via the internet and for its subscribers at a reasonable price through a service center. Since February 8, 2007, the Company has operated a unified service center, by a network code set by the Ministry of Communications (1344), including for the cellular operators and for HOT. This is additional to the Company's 144 service. It is noted that on February 7, 2007, a company that will become a telephone information service company in the future, filed a petition in the High Court of Justice against the continued provision of 144 services by the Company.

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

2.2.3 <u>Internet access services</u>

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

At the end of 2006, the Company had approximately 891,000 ADSL subscribers (compared with approximately 800,000 subscribers at the end of 2005), amounting to approximately 65% of the broadband internet market in Israel (based on items in the Israeli media regarding the number of subscribers who are not subscribers of the Company).

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

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

2.2.4 <u>Transmission and data communications services</u>

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

2.2.5 <u>Other services</u>

A. <u>Services to communications providers</u>

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, *inter alia* to international carriers, rental of space and provision of services at rented space, and provision of rights to use underwater cables.

B. <u>Satellite and broadcasting services</u>

The Company provides satellite services via fixed antennas (in the Ella Valley and the Ramla area), mainly including services for international communications: video

transmission services and satellite relay broadcasts for foreign broadcasting organizations in Europe and Asia. The Company also operates mobile units for television broadcasts via satellite from time to time. The Company is also in negotiations with customers for the provision of internet services via satellite.

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

The Company also currently operates and maintains seven radio networks operated by the Israel Broadcasting Authority, Channel 1's television transmitters and those of Educational Television, Channel 2's television transmitters and the transmitters of four regional radio stations. The Company is only responsible for operation and maintenance of the transmitters in order to distribute broadcasts of radio and television programs, and not for the content of the broadcasts. In this regard, see also section 2.15.2 below.

C. Work as a contractor

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

There are agreements for the provision of installation and maintenance services of cable networks for cable television between the Company and two cable television broadcast licensees which were recently merged using the Company's infrastructure, from the starting point of the above licensees' operating point up to the point of delivery at the entrance to subscriber homes (the connection and maintenance from these points up to the subscribers' homes is not within the Company's responsibility).

D. IP Centrex

The IP Centrex service is a virtual private exchange service. The Ministry of Communications wrote to the Company requesting that the Company prepare a service portfolio for the purpose of provision of this service.

2.3 Breakdown of Revenues and Profitability of Products and Services

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

	2006		2005	
	NIS millions	% of revenues	NIS millions	% of revenues
Telephony	4,088	71	4,262	72
Internet	608	10	550	9
Transmission and data communications	711	12	691	12
Other services	392	7	390	7

2.4 Accounts Receivable

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 63%) and the business sector (approximately 37%).

2.5 Marketing, Distribution and Service

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

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

2.5.3 Under the new collective agreement signed between the Company and the workers' organization, the Company is currently restructuring its organization, based, *inter alia*, on a transition from a geographical structure to a functional, customer-focused structure. In this context, the geographical divisions have been cancelled, and two new divisions have been set up – a private division and a business division. In this regard, see also section 2.9.1 below.

2.6 Competition

As part of the trend towards mergers in the communications market, the mergers of Netvision, Barak and GlobeCall were approved, as was the merger of Internet Zahav and Golden Lines. In this regard, see also updates to sections 4.6.1.1 and 4.6.2.1 below.

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

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

In December 2006, the Minister of Communications appointed a public commission, headed by Professor Grunau, to formulate detailed recommendations concerning the policy and principles of competition in communications in Israel. The letter of appointment stated that the Commission is requested to formulate its recommendations, *inter alia*, on the following important issues: The question of the need to separate out sectors of operation (transmission / content); the issue of the operation of consolidated communications groups, including rules for structural separation imposed on the Bezeq group and others. The Commission would also discuss the marketing of service packages and tariff flexibility for the Company and access of competitors to the infrastructures of licensees, the Company, the cable company and others (while examining different models, such as breakdown into segments). The Commission would also discuss a format for regulation in a world of convergence of mobile and fixed communications and voice, video and data services, including broadcasting on the platforms of communications operators, such as ADSL, cable, cellular – whether IPTV or other methods. Another subject to be discussed is the extent of the universal service obligation imposed upon communications operators. The deed of appointment further states that the Commission shall be permitted to extend the list of issues, should it find that such are essential for the formulation of its recommendations.

At the beginning of January 2007, the public was invited to present positions on the subject and to comment on the above. The Commission started its work in February 2007. According to a notice of the Ministry of Communications, the Commission will submit its recommendations within about six months. The Company is formulating its position on the issues, which it shall present to the Commission. The recommendations of the Commission, which will relate to the most important issued for the market and for the Company, are likely to involve changes in the principles of competition currently in place, and the Company is unable to assess the related trends or influences.

2.6.1 **<u>Telephony</u>**

In November 2003, **HOT** was granted a license for the provision of fixed-line domestic services, including telephony. On November 25, 2004, Hot began to supply telephony services.

On August 1, 2004, a temporary order entered into effect, stipulating that for a period of two years from the date on which HOT began its commercial activities or until a difference of up to 1.05 billion traffic minutes is generated between calls that end on the Company's

network and those that end on HOT's network, whichever comes first, interconnectivity fees for termination of the calls on said networks would not be paid (the "Bill and Keep Arrangement"). After a hearing (conducted in writing) on the intention to extend the Bill and Keep Arrangement by nine months, the Ministry of Communications notified the Company, on December 4, 2006, that the Ministers of Communications and Finance were considering extending the benefit granted to HOT in that arrangement, in a different format of setoff from the royalties which HOT is required to pay to the State. The Company replied to the Ministry that extension of the arrangement, even in its proposed new format, is harmful to competition and the Company, and that it is tantamount to direct financing for a competitor by the State. The Company requested to present its arguments in a hearing, among other reasons because it contends that that the arrangement and the subject are new. To the best of the Company's knowledge, no amendment to the Royalties Regulations has yet been brought before the Knesset Finance Committee (see Note 29 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report).

Competition with HOT is increasing, and is expressed, *inter alia*, in offers by HOT which combine broad band internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers. According to media reports, HOT's telephony service has more than 200,000 customers, as at the end of 2006.

The Company petitioned the High Court of Justice against the Minister of Communications, in an application for immediate enforcement on HOT of its obligations and commitments under its license, concerning structural separation. From the response of the State to the petition, it transpires that the Ministry of Communications had informed HOT that failure to implement structural separation constitutes a material breach of the terms of the license, and HOT was requested to notify the Ministry of its actions for fulfillment of its obligation for structural separation. In the hearing on the petition which took place on March 29, 2007, the Company reached an agreement with the State to the effect that the hearing of the petition would be adjourned by six months, by which time the State undertook that a decision would be passed by the Grunau Commission, and that the State would adopt the decision with regard to structural separation.

Following the adoption of the recommendations of the Kroll Commission, which was appointed to set guidelines for competition in the area of fixed-line telecommunications, and the accompanying legislative amendments, as of September 2004, the Minister is entitled to issue special general licenses for the provision of fixed-line domestic telecommunications services, including telephony, with no obligation to provide universal service or minimal geographical deployment. To the best of the Company's knowledge, such licenses were granted to GlobeCall limited partnership (which was merged with Barak and Netvision), Cellcom Fixed-Line Communications Services limited partnership, 012 Telecom Ltd. and Partner Fixed-Line Communication Solutions. The Company's subsidiaries Bezeq International and Pelephone have also applied for licenses (see sections 3.7.4 and 4.1.2.2 below).

VOB[10]Service Policy

On January 31, 2007, the Ministry of Communications published a policy for regulating and licensing the provision of VOB services. The policy replaces an earlier policy published by the Ministry in November 2004.

At the time of publication of the policy in November 2004, licenses were granted for marketing trials for VoIP services to a number of entities, including Golden Lines, Barak 013, and the subsidiaries Bezeq International and Pelephone. Most of the trial licenses remained in effect until publication of the new policy on January 31, 2007, however, the entities which have, in the meantime, received special general licenses for the provision of domestic fixed line communications services (see this section 2.6 above), continue to provide VOB services under those license. The trial license of the subsidiary Bezeq International was extended (see section 4.1.2.3 below). It is noted that the Company's request to the Ministry of Communications on March 16, 2006, for a marketing trial of VOB for payment (despite its clear position that is entitled to provide the service under the terms of its license), was turned down.

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[10] Voice Over Broadband

Under the new policy document of January 31, 2007, the Company and its subsidiaries will be permitted to provide VOB services only after the Company's market share in fixed-line domestic telephony in a particular segment (business or private) falls below 85% (the calculation of market share will be made according to the amended policy document – "Bezeq's License – Policy Highlights concerning Economies of Scale and Baskets of Services", dated January 9, 2005 – see section 2.16.2 below). Concerning DBS, the test point will be set on the day after the elapse of one year from the effective date (February 1, 2007), when the possibility of granting it a VOB license will be examined to see if its competitive status has deteriorated, and noting the situation of the competition in fixed-line domestic telephony.

On the matter of the call termination tariff in the network of a VOB operator, it was determined that it will be the same as the payment for call termination in a public telecommunications network of a fixed-line domestic operator (i.e. the same as the payment which the Company receives for terminating a call in its network), for a period of two years from the effective date. No later than by the end of two years, the Ministry will re-examine the arrangement, noting, *inter alia*, the actual development of competition in the field.

According to the policy document, the Company will also not receive additional payment from a VOB operator who uses its network, beyond the payment made by the end user for the broadband access service.

The regulation for the provision of a private organizational network in IP technology for transferring calls, will be similar to that for network end point services. In this context, the policy document notes that the Ministry of Communications intends to adapt the network end point service licensing policy for a body that is one legal entity even if not in continuous premises, and to consider expanding the use of the IP/VPN service to intra-organizational telephony.

An immediate report of the Company stated that the application of these decisions could result in significant harm to the Company and its subsidiaries and their ability to compete.

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

The Company wrote to the Ministry of Communications several times, including a letter requesting temporary suspension of the directive until after an appropriate cost-based usage price could be set, and a letter concerning the policy, stating that denying the Company the ability to provide VOB services was unlawful and unreasonable, and even if a reason could be found for limiting the Company, it could not be done without delineating the limitation to a reasonable and concrete time period and not only market size. The Company also requested that the market shares be measured on the basis of minutes and not revenues. These letters have not yet been answered.

For the positions of the subsidiaries Bezeq International and Pelephone in this regard, see sections 3.7.4 and 4.1.5 below.

2.6.2 Broadband internet access

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

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

The Company estimates, based on various items in the media, that HOT serves more than 470,000 high-sped internet customers on its cable network.

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 in the doing of these actions 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.

At the beginning of July 2006, Partner announced that it had concluded a transaction to acquire the transmission operations of Med-1. On August 15, 2006, Partner was granted a special license for providing transmission and data communication services, after purchasing the operations of Med-1 as aforesaid. Purchase of the operations of Med-1 by Partner might make competition in this field stronger, whilst harming the Company's revenues from services that it provides to Partner.

2.6.4 Competition from the cellular companies

The penetration rates of cellular technology in Israel are among the highest in the western world. The Company's opinion, which is not accepted by the Ministry of Communications or the Antitrust Commissioner, is that the penetration rate, combined with airtime tariffs which are low in international terms, have made cellular phones a product which is largely interchangeable with telephone lines. Over the past two years, there has been steady erosion, albeit at varying rates, in the number of voice minutes over the Company's network, as a result of a slow-down in the pace of growth of the cellular companies. There has also been an increase rise in calls from the networks of fixed-line domestic operators to the cellular networks. The Company believes that increasing interchangeability between fixed-line and cellular telephones is one of the reasons for the growing rate at which telephone lines are being removed, to the extent that approximately 15% of Israeli households today do not have a fixed line of the Company (compared to approximately 5% in 1996). Based on 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 regarding fixed-line telephony services. At the Tribunal's suggestion (in light of the time that has passed since the appeal was submitted together with an economic opinion), the Company agreed to withdraw the appeal, which was expunged on August 2, 2006. The Company is getting ready to submit a new, updated application to the Antitrust Commissioner.

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

Partner Fixed-Line Communication Solutions has also been granted a license for providing fixed-line domestic services.

2.6.5 VOD[11] Service Policy

On January 10, 2007, the Ministry of Communications published a proposed policy for the licensing and regulation of VOD services over a broadband infrastructure. According to the document, it is proposed to amend the Communications Law so as to enable new licenses to be granted for these services. In addition, the document proposes that DBS be permitted to provide VOD services on the Company's ADSL infrastructure, with limitations that will apply with regard to that infrastructure: the Company will be required to allow a VOD licensee and DBS to use the ADSL infrastructure for providing VOD services on equal terms; the Company will be given usage instructions according to Section 5 of the Communications Law; and payment will be equal and transparent, and will include the cost deriving from connection of the service provider to the network.

Furthermore, the Bezeq Group – except for DBS – will not be allowed to provide VOD services, not will the Company be allowed to be involved in any other way in providing the services (including by way of marketing packages of services); and in the matter of the end user, the Company will offer a broadband access service to the VOD provider on equal terms. On this matter, two options are being considered: the subscriber will receive two bills – one from the Company and one from the service provider, or – the service provider will be a collection channel only.

The document also proposes that HOT be required to allow access to these licensees, if and when it requests to provide VOD services in IP technology.

On February 15, 2007, the Company submitted its position to the Ministry, stating that with the change in the condition prohibiting the Bezeq Group from being a VOD service provider, and where the policy encourages investment of the considerable amounts required for upgrading the infrastructures in order to realize the ability to convey content, the Company will act to make the necessary investments for providing the services, and will enable access also for other entities on equal terms. However, if this essential condition is not allowed, the Company will be unable, out of business considerations, to agree to the proposed policy, and does not intend to make the investments required for providing VOD services.

On March 15, 2007, the Ministry of Communications published its final policy document on the issue of VOD, to which no substantial changes were made compared with the proposed wording. The form of a proposal to amend the Communications Law so as to allow the grant of new licenses for the provision of VOD services was attached to the policy document.

In this regard see also section 5.6.5(f) below.

2.6.6 Additional factors that may affect competition

A. Numbering and number portability

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

On March 29, 2005 the Economic Policy for Fiscal 2005 (Legislative Amendments) Law, 5765-2004 was passed by the Knesset, containing, *inter alia*, an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (hereinafter: the "**Communications Law**"), whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006 (if the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone, in an order and with the

[11] Video On Demand services.

approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months).

Notwithstanding the countless letters, official reports and approaches by the Company other licensees and entities, such as the chairman of the Forum for Implementation of Number Portability, stating that it is not possible to comply with the timetable (and the Company also wrote to the authorities in this regard even before the law was enacted), no action was taken to postpone the dates and set realistic timetables for implementation of number portability.

In this regard, in January 2006, the chairman of the Forum wrote to the Minister of Finance requesting to hold a hearing for all of the carriers regarding the timetable, and proposed amending the Law so that completion of implementation would be postponed by one year.

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

In June 2006, the Company once again applied to the new Minister of Communications, asking the Minister to act to enact an amendment to the Communications Law in order to prescribe a reasonable timetable for implementation of number portability. On August 2, 2006, a letter was sent to the Company from the Supervision Department of the Ministry of Communications, containing a summary of supervision regarding the Company's compliance with the number portability plan. According to the claims made in that letter, the Company is not in compliance with the timetables set for implementation of number portability, and the Company's explanations for such were not accepted. On August 8, 2006, a letter was sent by the Company in response to this letter, explaining that the summary of the discussion was not, in the Company's opinion, in accord with the spirit of the discussion on the matter, that the Ministry's good impression of the Company's acts was not expressed in the summary and that it had not been possible to commence making preparations earlier, prior to the formulation of a characterization plan, and prior to formulation of full characterization by the Ministry of Communications. On August 7, 2006, a letter was sent by the Chairman of the Number Portability Forum to the Minister of Communications, requesting the Minister to act to postpone the date of implementation of the plan.

It is noted that concurrently with the aforementioned correspondence, the Company is using its best efforts and is investing considerable resources in order to advance the implementation of number portability on its systems.

On August 23, 2006, the Ministers of Communications and Finance announced that implementation of the plan would not be postponed beyond September 1, 2006. The Ministers' notice also stated that the Director General of the Ministry of Communications had recommended that if the plan is not implemented and operated by that date, "the relevant communications companies would be declared in violation of the law, with everything that entails". Following this decision, on August 24, 2006 both the Company and Pelephone (as well as other cellular companies) filed petitions in the High Court of Justice for a decree nisi against the Government of Israel and the Minister of Communications. The petitioners allege, *inter alia*, that even though they had worked assiduously for implementation of the plan, investing considerable resources for the purpose, they are unable to meet the unrealistic timetables set in the law for its implementation. Moreover, the petitioners alleged that the Ministry of Communications had failed to prepare a number portability plan and had not prescribed a structure for the payments that would apply among the operators, as the Law requires. The State filed its preliminary response, in which it requested that the petition be dismissed *in limine*. The hearing of the petition has been postponed to July 30, 2007. On this matter, see also Note 17C to the financial statements of the Company for the period ended December 31, 2006, included in this periodic report.

The Company has given notice to the Ministry of Communications that, subject to the success of the testing being run between the carriers (which the Company has

undertaking to commence no later than July 1, 2007), the Company shall be prepared to implement the plan on December 1, 2007.

B. Other potential competing infrastructures

In addition to the cable companies' cable and fiber-optic network and Cellcom and Partner's fiber-optic infrastructures, there are a number of fiber-optic networks in Israel today, most of which are owned by State-owned companies or government agencies. These include Israel Electric Corporation, Israel Railways, Mekorot, the Oil Infrastructure Company and the Cross-Israel Highway Company. At this stage, there is no use of the aforesaid infrastructure in competition with the Company. Some municipalities are also attempting to create an alternative to the laying of pipelines by communications licenses, via the infrastructure held by such municipalities. During 2006, Tel Aviv-Yafo Municipality contacted the Ministries of Justice and Communications concerning the laying of infrastructures by communications companies within its jurisdiction and the use of municipal infrastructures, in an attempt to receive authorizations and impose additional restrictions on the communications companies in that context. The Company opposes the position of the Municipality, and submitted its comments to the two ministries.

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

C. Advantages and technological developments

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

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

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

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

In the business sector there is also a common trend of bypassing the Company's switched telephony network, either through cellular adaptors installed by the customers themselves or by the cellular companies (installations on the customer's

premises enabling conversion of calls originating from a fixed line to the cellular spectrum) or by NEP licensees.

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

2.6.7 <u>The Company's preparations for coping with increasing competition</u>

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

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

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

C. The Company is constantly working to improve the quality of its services and to preserve its customers, and since the end of 2005, these activities have been run as a special project, which focuses solely on them.

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

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

F. The Company is working to heighten awareness of use of the fixed-line telephone and to promote the use of other services which increase telephone use, such as numbering services (1-800), voice mail, marketing of digital cordless phones (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' position was 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 disputed the position taken by the Ministry of Communications and has appealed to the High Court of Justice in this matter. The High Court of Justice issued an order staying rescission of the existing agreements and the calling in of the guarantee pending hearing of the case.

   On March 28, 2005, the High Court of Justice ruled that the interim order staying rescission of the agreements between the Company and business customers be left in place pending further ruling. However, in the same ruling, the High Court of Justice stated that there was nothing to prevent forfeit of the sum of NIS 8 million by the Ministry of Communications, out of the bank guarantee given to it by the Company. As at the date of publication of this report, the Ministry of Communications has not taken any action relating to forfeit of the guarantee. "Hot-Telecom" has been joined as a respondent in the petition. On November 17, 2005, a hearing was held in the petition, and as at the date of publication of this report, a ruling has yet to be handed down. On March 27, 2007, a judgment was handed down dismissing the petition. As a result of this ruling, the Company is preparing to rescind the agreements and has given notice of such to the Ministry.

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

I. At the end of 2005, a change administration was set up at the Company in order to implement changes in the organizational structure of the Company, the purpose of which was to make the Company more compliant with a competitive market, by focusing on customers, and achieving operational and procedural efficiency. After execution of the new collective agreement, the Change Administration is acting in order to implement and assimilate the new organizational structure of the Company (see section 2.9.1 below).

J. The Company is looking at how it will integrate itself into a process which is hitting most of the communications companies around the world, to deploy a unified infrastructure, under a network topology known as the Next Generation Network (NGN) for transmission of voice communications, high-speed internet communications and content, leisure and entertainment applications. With regard to this matter, see Section 2.6.5 below. The decisions of the Company on this matter will be taken subject to the regulatory policy on content, an issue which is included in the letter of appointment of the Grunau Commission (see section 2.6.1 above).

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

Positive factors

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

B Presence in most businesses and households.

C. Strong capital structure and positive cash flow.

D. Expansive service infrastructure and various customer interfaces.

E. Professional, experienced and trained staff.

F. Brand with presence and power.

G. Tariffs that are among the lowest in the world.

Negative factors

Regulation

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

A. Obligation of structural separation

Under its license, the Company must maintain full structural separation, in the form set out in the license, between itself and those subsidiaries and affiliated companies that are specified in the license. At this stage, these restrictions do not apply to the other organizations operating in the communications market, and thus put the Company in an inferior position. There is also a separation between the Company's operations and those of Pelephone due to the conditions of the merger approved by the Antitrust Commissioner.

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

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

C. Lack of tariff flexibility

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

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

The Ministry of Communications has started to intervene in marketing campaigns offered to the public by the Company, a position to which the Company objects since it is permitted to launch such campaigns for limited periods without having to obtain the prior approval of the Ministry.

D. Universal service obligation

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

E. Cross-subsidy

Due to regulation, the Company's tariffs include a cross-subsidy between traffic and access. This issue is in any case one of the most substantial difficulties the Company has in competing, and yet the competition relies on Bezeq's infrastructure and takes advantage of the access subsidy (such as VOB Services), so the negative impact of this factor has grown. As noted in the preamble to this section 2.6, in December 2006, the Grunau Committee was set up to formulate recommendations regarding policy and rules of competition in the field of communications in Israel, which is to recommend changes in the above.

Labor relations

Labor relations in the Company, some of whose employees are subject to collective labor agreements, make flexibility of its operations and its ability to deal with competition more difficult.

Competition

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

2.7 Property, Plant & Equipment

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

2.7.2 Fixed-line domestic telecommunications infrastructure

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

A. Exchanges

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

B. Transmission network

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

C. Data communications networks

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

D. Access network

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

E. Terminal Equipment

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

2.7.3 Computing

The Company's IT system supports four central areas:

A. Marketing and customer management

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

B. Information systems for engineering infrastructures of the telecommunications networks

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

C. Information systems for management of Company resources

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

D. Cross-organization systems

Support decision-making processes via a data warehouse system (DWH) operated by the Company. The Company also has an internet site which provides information regarding the Company's services, and allows for the presentation of information regarding telephone bills, payment of telephone bills and additional services. Computerized office systems (electronic mail, resolution follow-up, etc.), knowledge management systems, etc. are also operated by the Company.

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

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

2.7.4 Real Estate

A. General

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

The Company owns or has long-term leases over some 415 real estate assets around the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights), amounts to some 710,000 m^2 of land, of which some 370,000 m^2 is built up. Six of these properties are in Israeli settlements in Judea and Samaria, approximately 7,000 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 long-term, 66 of them are properties which were under joint title with the Ministry of Communications, the rights of the Ministry in most of which having been transferred to the Postal Authority, to the best of the Company's knowledge. The total area of these properties is some 126,000 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 2.17.2(c) below). The parties are following the provisions of the agreement, *inter alia*, to separate joint charges and systems.

Furthermore, the Company holds some 75 properties in Israeli settlements in Judea, Samaria and the Gaza Strip, in a total area of approximately 10,500 m^2 of land, on which about 1,800 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 development, and can be exploited further.

The Company leases about 130 land assets, with a total area of 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 330 concentration rooms at its disposal (rooms for cables and installations for the purpose of neighborhood communications), with a total area of approximately 4,400 m^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 most of the real estate assets transferred to the

Company under the real estate transfer agreement which was executed when the Company began its commercial operations.

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

As at the date of publication of this periodic report, of the abovementioned assets, the Company has returned 13 assets to the ILA.

In addition to the Properties to be Retained by the Company, about 220 properties under long- term leases stipulated in the real estate transfer agreement (hereinafter: the "Properties under Long-Term Lease"), with the exception of a number of properties of an insubstantial cumulative value, are to be returned to the State. Of all the properties under long-term lease, 66 are held jointly by the Company and the Postal Authority and/or the Ministry of Communications. It was determined that the rights of the Company in these properties under the Settlement will also be determined by the area in the use of the Company in said properties as will be determined or agreed upon in the future between the Company, the Postal Authority and/or the Ministry of Communications, as applicable (in this regard, see Section 2.17.2(c)). Note that over the years (both before and after the Settlement), the Company has sold approximately 20 assets (in whole or in part) out of the properties under long-term lease, such that as at the date of this periodic report, there are approximately 200 assets in this group of assets.

D. Properties with improvement potential

Pursuant to a settlement agreement which removed uncertainty regarding the rights of the Company in the assets that the Company retains, and defined them, the Company started working on exercising the improvement potential of them, such as by exploiting construction rights, amending plans under the Planning and Building Committee, and selling assets. The considerations are mainly based on criteria of the size, location and use of the real estate.

During the course of 2006, the Company sold 14 real estate assets in a total area of approximately 986,000 m^2 in land and approximately 13,200 m^2 built-up, for a total sum of $ 46 million.

2.8 Intangible assets

2.8.1 The Company's general license

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

2.8.2 Trademarks

The Company uses trademarks that reflect its products and services.

As of the date of this periodic report, the Company has approximately 90 trademarks registered in its name at the Registrar of Patents and Trademarks. The main trade marks are:

"Bezeq" – Company name.

"B BEZEQ" – Company logo.

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

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

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

2.9 Human Resources

2.9.1 Organizational Structure and Employees According to Organization Structure

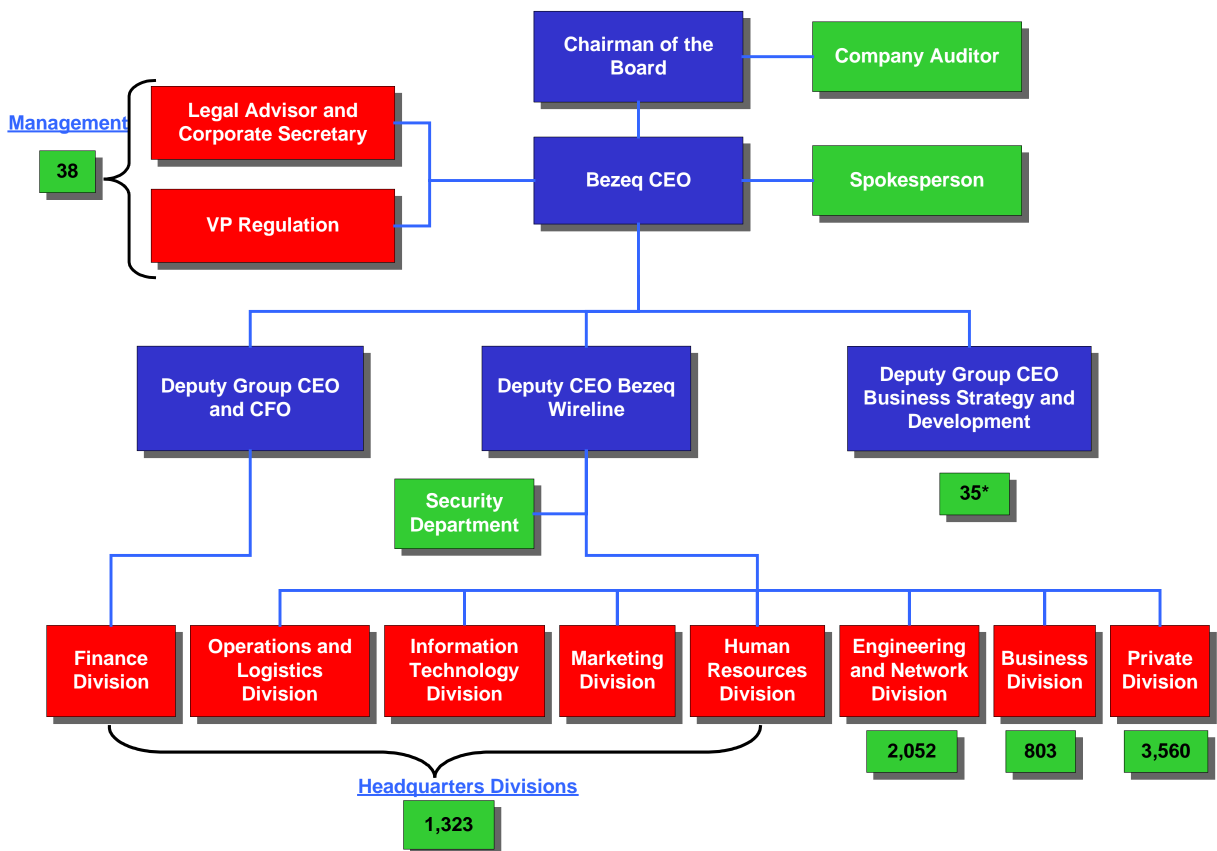
During 2006, the Company worked in coordination with the workers' organization in order to bring about a change in the Company's organizational structure, with the aim of making the Company compatible with the competitive market in which it operates, by focusing on the customer and achieving operational and procedural efficiency.

As a result, on December 5, 2006, a new special collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company. The main points of the agreement are set out in section 2.17.4 below.

A change administration is working in the Company on concentrating and coordinating the change plan, is responsible for designing the new organizational structure, for designing the new processes, for determining the necessary human resources and job descriptions, and for preparing the implementation and adaptation plan. The change administration is also responsible for defining indexes and goals and coordinates the work of all of the Company's improvement teams operating on a variety of core issues.

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

The following is a sketch of the general organizational structure of the Company after the changes:



* Including employees of the Inmarsat unit at the Company

2.9.2 Personnel according to employment framework

Employment Framework	Number of Employees		Description of Employment Framework
	As at 31.12.06	As at 31.12.05	
Contracts for senior executives	84	87	Managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.
Permanent	3,929	3,992	Employees employed through collective bargaining agreements.
Overall salary contracts / personal contracts	1,114	1,012	Employees employed through personal contracts that are not part of the collective bargaining agreements.
Ranking contracts	279	264	Employees employed through personal contracts under the terms of the collective bargaining agreements for a period of six years on a track that will make them permanent employees.
Age contracts	36	36	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.
Temporary hourly employees & temporary monthly employees	2,258	2,702	Employees engaged in defined activities, which in the past were staffed by workers from employment agencies. The conditions of employment of employees in this category were recently updated in the special collective agreement of December 5, 2006.
Hourly agreement	383	0	Employees employed under an hourly agreement as of July 11, 2006.
Temporary	13	15	
Total	8,096	8,108	

2.9.3 Orientation and retirement of employees from January 1, 2006 through December 31, 2006

Employment Framework	Intake	Retirement
Senior Contracts	12	16
Permanent		107
Ranking contracts		12
Temporary		1
Overall salary contracts	45	98
Temporary hourly employees & temporary monthly employees	561	772
Hourly agreement	489	113
Total	1,107	1,119

Note that between January 1, 2007 and March 31, 2007 approximately a further 400 employees retired from the Company.

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 2006 was approximately 28,500 days, reflecting an average of 3.1 days of

training per employee. This training activity includes, professional training in the fields of technology, sales, management, service and others.

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

The Company's total investment in training activity in 2006 amounts to approximately NIS 2.4 million and approximately NIS 0.9 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.

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

2.9.6 Employee Reward Schemes

On November 15, 2005, the Company published an outline of an offer of the State's shares to employees of the Company. The offer is for up to 122,697,648 options, exercisable for up to 122,697,648 shares of the Company held by the State of Israel and constituting approximately 4.71% of the shares in the Company, and exercisable in three equal portions after approximately two years, three years and four years following the date of allotment. In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

On February 22, 2007, the board of directors of the Company approved an employee option scheme and on the same date, the Company published an outline with respect to the scheme.

Under the scheme, the Company shall issue its employees with options exercisable for shares at 3% of the issued share capital of the Company, at an exercise price (adjusted for each kind of distribution etc.), of 50% of the last closing price of the share prior to the date of issue, (apart from senior management staff), for no consideration, in accordance with criteria prescribed in the collective agreement of December 5, 2006.

Accordingly, on March 25, 2007, the Company allotted 78,091,794 options (out of a total sum of 78,151,368 options[12]) to employees, exercisable for 78,091,794 ordinary shares of the Company of NIS 1.00 par value each at an exercise price of NIS 3.201 per share, linked to the CPI for February 2007 (adjustments for all kinds of distributions etc. shall apply to the exercise price). The options shall be blocked for a period of two years as of the date of issue of them, and shall be exercisable over three years from the end of the blockage period.

The total value of the benefit to the employees under this scheme, according to the opinion of an external economic adviser, and based on the price of the Company's share as at February 18, 2007, is approximately NIS 170 million. However, the recording of the expenses for this scheme for accounting purposes cannot take into account the effect of the obstruction arrangements in the options, and therefore, the Company has recorded the sum of approximately NIS 287 million as a salary expense in its financial statements (see Note 26 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report).

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

[12] The rest of the options shall be issued to two directors from among the employees, subject to and following the approval of the general meeting of the shareholders of the Company, which is expected to take place on April 15, 2007, at an exercise price of 50% of the share price on the date of issue of the options.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 16 directors[13] and -13 senior executives.

The two external directors acting on the board of directors of the Company receive remuneration in accordance with the Companies (Rules Regarding Remuneration and Expenses of an External Director) Regulations, 5760-2000. The other directors of the Company, apart from the chairman, do not receive any remuneration or salary for their office as directors. The chairman is an employee of the Company (see section 12 of chapter D in this periodic report).

For the management agreement between a management company owned by the shareholders of Ap. Sab. Ar., see section 2.17.5 below and Note 29(e) to the Company's financial statements for the year ending December 31, 2006, included in this periodic report.

The senior members of management are employed under personal agreements which include, *inter alia*, pension coverage, the payment of bonuses based on goals and prior notice months. The Company intends to act to approve a remuneration scheme for directors instead of the option scheme which was cancelled on March 15, 2007.

For cancellation of the bonuses to the members of management of the Company, see section 7 of Chapter D in this periodic report, and Note 29 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

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

2.10.2 The following table lists the percentage of Company purchases in 2006 from the main suppliers and the type of contractual arrangement with them:

Main Products	Main Supplier	Type of Contractual Arrangement	% of Purchases out of Total Purchases in Area of Activity
Public switching equipment	Nortel	Framework agreement for purchase, upgrade and maintenance, which was renewed at the end of 2004 until the end of March 2007.	Approximately 8%
Public switching equipment	Alcatel	1. Agreement to purchase equipment 2. Agreement to purchase number portability system, with option to upgrade existing switches. 3. Maintenance agreement that renews each year.	Approximately 10%
Billing – computerized billing systems	Amdocs	Framework agreement for the provision of personnel for support, guidance and integration of the systems.	Approximately 9%
Transmission equipment	Supplier D	Framework agreement for purchase and maintenance until the end of March 2008.	Approximately 8%
IP/VPN – IT equipment and integration work	Supplier E	Framework agreement that can be extended each year until the end of October 2010.	Approximately 6%

[13] Including two external directors and two directors from among the employees.

2.10.3 The Company believes that it is dependant on two suppliers of public 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.

2.10.4 In order to perform the obligations regarding number portability between the various communications licensees, the Company is in various stages of contracting or performing projects with various suppliers, including purchasing new systems and making adjustments to existing systems. The contracts include purchases of new computer and switching systems, and effecting changes, adjustments and upgrades of existing systems used by the Company to provide services to its customers, and in enveloping systems used by the Company to support these 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 2006:

	Scope of average credit in NIS millions	Average credit days
Accounts Receivable	867	EOM + 16
Accounts Payable	362	EOM + 29

2.12 Investments

For information on investments in subsidiaries, see Note 32 to the financial statements for the year ended December 31, 2006, which are included in this periodic report. See also Sections 3 and 4 in Chapter 4 of this periodic report.

2.13 Financing

2.13.1 **Average interest rate on loans**

As at 31 December 2006, the Company is not financed by any short-term loans (less than one year).

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

Source of financing	Type of currency or linkage	Rate of average interest
Non-banking sources	CPI linked NIS	4.7%
	Euro[14]	6.5%
	NIS-Linked Euro	EURIBOR + 0.8%, i.e. 3.24763% as at December 31, 2006.

2.13.2 **Restrictions on receipt of credit**

A. With respect to limitations on Company loans – see Note 13 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

[14] See section 2.13.7 below.

Note that following repayment of the balance of the long-term dollar loan in the NIS equivalent of NIS 430,000 [sic], the Company's obligations regarding the restrictions imposed upon it under the above loan agreement, including the obligation to comply with a net financial debt ratio to operating profit before depreciation (EBITDA) of no more than 3:1, for the Group.

B. Restrictions 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

No loans were taken in 2006.

2.13.4 Credit received after December 31, 2006

The Company has not taken any loans since December 31, 2006.

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, 2006):

Type of linkage	Change mechanism	Financial scope	Interest range in 2006	Current interest rate
Euro and Euro-linked	Libor – EUR 6M	30	2.62650%-3.24763%	3.24763%

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

2.13.6 Credit rating

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

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Maalot	AA	March 28, 2005 – AA rating received (no change in rating) May 10, 2005 – rating on Watch List. April 4, 2006 – Company's existing rating (AA) ratified and validated after renewed checks of the commercial risk, the financial risk and the Company's strategy, and following sale of the core of control of the Company to Ap. Sab. Ar. Holdings Ltd.	All series of debentures*
Midroog	Aa1 (Watch List)	March 24, 2005 – Rating changed from Aa1 (Watch List) to Aa1 (Negative). May 16, 2005 – rating moved to Watch List for examination of possibility of downgrading rating. April 11, 2006 – rating taken off the Watch List and left at Aa1. Rating forecast lowered from stable to negative so as to reflect the possibility that a change in ownership of the Company might affect the Company's future commercial and financial profile.	Debenture series (4) and (5)
Standard & Poors	BBB+	May 10, 2005 – rating moved to Creditwatch, with negative implications. October 11, 2005 – credit downgraded to BBB and to remain on Creditwatch, with negative implications. February 28, 2006 – rating remains on BBB+ and rating taken off Creditwatch. Rating forecast negative.	The rating is for the Company
Moody`s	Baa1	March 7, 2003 – change of rating from A3 (Stable) to A3 (Negative). October 11, 2005 – rating downgraded to Baa1 and kept on review for possible further downgrade. February 6, 2006 – rating left at Baa1 and held to be 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 (2007) and sources of financing

The Company is expected to repay part of its loans during the course of 2007. The main sum to be repaid stems from repayment of the principal of the Eurobonds which is due to fall in August 2007, in the sum of approximately NIS 1,630 million. The Company intends to raise additional debt in 2007, *inter alia* in order to repay the Eurobonds. The financing options open to the Company are: Raising debt by the sale of series 5 debentures held by a wholly-owned subsidiary, Bezeq Gold (Holdings) Ltd., raising debt by new loans from banking corporations and/or by raising debt or capital on the capital market.

2.13.8 Liens and guarantees

For information regarding the Company's liens and guarantees, see Notes 13 and 19 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.14 Taxation

For information regarding taxation, see Note 8 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.15 Environmental matters

2.15.1 <u>Regulations on facilities emitting electromagnetic radiation and proposed legislation</u>

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.

2.15.2 <u>The Non-Ionized Radiation Law, 5766-2006</u>

On January 1, 2006, the Non-Ionized Radiation Law, 5766-2005 (the "**Law**") was published and most of the provisions came into force on January 1, 2007.

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

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

The Law includes Amendment No. 75 to the Planning and Building Law, 5725-1965, which provides that a planning institute is to be entitled to demand, as a condition for the grant of permits to erect cellular installations, deeds of indemnity against claims for compensation under section 197 of the Planning and Building Law, 5725-1965, and until provisions are made in this regarding the National Outline Plan, such demand shall be in accordance with the guidelines of the National Planning and Building Council. This provision applies as of the date of publication of the Law.

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

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

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

The Company has radiation permits from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment for all of the communications sites operated by it, with a few exceptions. With respect to those broadcast sites the radiation permits for which are about to expire, but for which no building permit was found, the Company received radiation permits for a number of sites from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment, and is in the process of receiving radiation permits for the remaining sites as well.

The Company has work procedures with respect to the set-up, operation and measurement of non-ionized radiation sources, and an appropriate compliance procedure which was approved by the board of directors of the Company.

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

2.15.3 With respect to permits for broadcasting installations that are required by the Planning and Building Law, 57251965, see Section 2.16.11 below.

2.15.4 With regard to claims filed regarding alleged radiation from the Hillel broadcasting station – see Note 17A(5) to the financial statements for the year ended December 31, 2006, which are included in this periodic report.

2.16 Restrictions on and regulation of Company operations

The Company is subject to a variety of laws which restrict its commercial operations. The principal body that supervises the Company's operations as a communications company is the Ministry of Communications.

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

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

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

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

A. During the course of 2005, the following amendments were made to legislation regarding the Company's tariffs:

1. On April 11, 2005, an amendment to the Communications Law was published under the Economic Policy for Fiscal 2005 (Legislative Amendments) Law, 5765-2004, which set out a uniform supervision mechanism (tariffs being set by the Minister of Communications with the consent of the Minister of Finance), with respect to the Company's supervised services.
2. This mechanism is set out in section 15, which provides that "The Minister, with the consent of the Minister of Finance is authorized to determine by regulation the payments for services provided to subscribers by the Licensee." (Hereinabove and hereinafter: the "supervised services").
3. In an Order dated May 31, 2005, the application of the Supervision of Prices of Commodities and Services Law, 5755-1996 was cancelled, having previously applied to part of the supervised services and having prohibited a person from selling a service during the course of his business at a price that is different from the price fixed.

B. The tariffs for the Company's supervised services, stipulated in 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.

C. Pursuant to section 15A of the Communications Law, if tariffs are stipulated for the supervised services under the above section 15, the Minister may, with the consent of

the Minister of Finance, approve the request made by the Licensee for an "alternative payment basket" for a package of services.

D. Under Section 17 of the Communications Law, "a Licensee may request a reasonable payment for a telecommunications service for which no payment is stipulated in Section 15." For these types of services provided by the Company (including broadband internet access service, business access, etc.) the Company sets tariffs and informs the Ministry of Communications of them in accordance with its general license. For additional provisions of the general license regarding tariffs, see section 2.16.2C. below.

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 then Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages. On January 9, 2005, non-significant changes were made to the policy paper. The following are the principles of the paper, after its amendment:

<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 Communications Law. Such size discounts will be determined by way of an alternative basket of payments according to Section 15A of the Law. The discount shall not apply to the services for which discounts higher than 10% are set today in the regulations. Note that on May 24, 2006, an additional payments package (in force as of June 1, 2006) was approved by the Ministers of Communications and Finance, which allows the Company to give volume discounts of up to 10%.

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

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

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

On March 15, 2006, the Company submitted a detailed position paper to the Ministry of Communications, in which it clarified that the requirement of loss of "market share" is vague and would be a broad basis for disputes, delays and legal actions; in the Company's opinion, the conditions for allowing the Company to market joint bundles with its subsidiaries have also come to fruition.

The Company has submitted the professional opinion of an external expert to the Ministry of Communications, which states that the appropriate test for measuring market shares is the minutes test rather than the revenue test. However, the Deputy Director General,

Economics, at the Ministry of Communications has given notice to the Company that he does not intend to hold a hearing on this matter with the Company. The Company wrote to the Ministry once again on December 7, 2006, asking to hold professional proceedings between the Ministry and the Company.

On September 12, 2006, the Company wrote to the Ministry of Communications reminding the Ministry of its request of March 19, 2006 that the Ministry handle the grant of relief to the Company regarding supervision of its operations in the areas of operation in which the Company's market share has fallen to less than 85%, as a matter of urgency. On October 3, 2006, the Ministry replied that it was examining the request with respect to high-speed internet, and that it would respond soon.

On September 19, 2006, the Company wrote to the Minister of Communications requesting that it fulfill the provisions of the clarification paper for candidates in the proceedings to privatize the Company, dated April 6, 2005, under which the Ministry intended to set down two "checking stations", the first in November 2006 and the second in November 2007, at which the Ministry would check the possibility of allowing the Company to sell service bundles which also included services provided by subsidiaries, even if the Company has not lost a market share of 15%. The Company requested that the aforesaid check be effected as soon as possible. On September 26, 2006, the Ministry responded to the Company stating that the check would take place based, *inter alia*, on the data regarding competitor operations in the domestic fixed line field, in the period of up to and including October 2006. To the best of the Company's knowledge, no check was performed on the first checking station as aforesaid, and in any event, the Company did not receive any notice with respect to such. For the permit to the Company and its subsidiaries to provide VOB services after the Company's market share in the field of domestic fixed-line telephony falls below 85%, see section 2.6.1 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, DBS, Bezeq On-line, and Bezeqcall Communications, and GoldNet which have, in the meantime, been merged into Bezeq International. (The Minister has the authority to expand the application of the rules of structural separation to an affiliated company[15], 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

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

is prohibited from transferring said information to the subsidiary. The Company has set such rules.

C. Tariffs

Should the Director General (according to the license: The Director General of the Ministry of Communications or a person authorized by the Minister with respect to licenses in general or with respect to this license in particular, as a rule or for a specific issue) announce that the Minister intends to set a tariff for a new service in accordance with Section 15 of the Communications Law, the Company shall not begin provision of the service before a tariff has been specified, unless the Minister so permits. The Company shall not charge a discriminatory price.

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

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

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

D. Investments in other fields and restrictions on cooperation

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

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

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

E. Numbering and number portability

For the numbering plan and number portability, see Section 2.6.6A above.

F. Operation of Company networks and service levels

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

G. Interconnectivity and use

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

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

H. Arrangements in the field of security

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

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

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

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

I. Liability and insurance

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

J. Control and reporting

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

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

K. Miscellaneous matters

The general license includes "cross-ownership" restrictions.

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

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

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

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

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

The Director General of the Ministry of Communications is authorized to impose a monetary sanction on breach of any of the terms of the license. For the increase of the sum of the sanctions, see section 2.16.13 below.

On December 23, 2004, the Ministry of Communications amended the Erotic Services Appendix to the Company's license, and the definition of "erotic service" was expanded in the licenses of the cellular operators. The meaning of a service being defined as an erotic service is that it is being subject to rules determined by the Ministry in this matter, including requirements for blocking. On June 8, 2005, the Ministry of Communications provided a draft appendix to the general licenses to the cellular licensees, HOT and the Company, for remarks, regarding replacement of the "erotic services" appendix with "adult services". Under the draft appendix, a variety of services that are not appropriate for minors, due to their nature and substance, will be regulated by way of use of access code 1919, instead of what the Ministry sees as the restricted arrangement of "erotic services". The proposed amendment extends the content that may be offered via the aforesaid prefix to all "adult services" such as introductions, chats, matchmaking, etc., and prescribes clear rules for "reliable identification" of an adult prior to removal of the block. The Company, without going into the main body of the matter, asked that the requirement to play a voice message to all subscribers blocked from the service not apply to a licensee which does not itself produce the service, since the technology by which the Company currently provides access to the service, and which was adopted based on the previous amendment to the license, does not enable this.

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

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

On October 18, 2006, the Ministry of Communications published a hearing for general licensees regarding the intention to regulate the issue of a "fixed transaction", by amendment of the licenses, to the effect that notices would be given to customers regarding termination of the obligation period, and the tariff to apply thereafter. Prima facie, the amendment imposes an operative burden on the Company, and it intends to express its reservations to the Ministry in this regard.

2.16.3 Royalties

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

The regulations that entered into effect on January 1, 2001, Telecommunications (Royalties) Regulations 5761-2001 (hereinafter: the "Royalties Regulations"), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscriber services in the Schedule to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. The revenues on which royalties must be paid as stipulated in the Schedules are as follows: For a Licensee providing fixed-line domestic telecommunications services (including the Company) – from January 1, 2004 – 3.5% on all revenues from the provision of telecommunications services that are attributable to charges of recipients of the Licensee's services, less revenues collected for another Licensee or which were transferred to another Licensee, or payments made to another general Licensee for completion of calls or their transfer on its telecommunications network, and less revenues from the provision of transmission service to other Licensees, revenues from a segment of transmission service via satellite, revenues from the sale of terminal equipment and bad debts related to revenues on which royalties must be paid. On August 31, 2006, an amendment was published to the Royalties Regulations regarding a reduction of the rate of royalties for all of the licensees who are required to pay royalties, as of January 1, 2006, in the rate of 0.5% per annum, up to a royalty rate of 1% per annum as of 2010. Likewise, the Ministry gave notice that it would act to amend the regulations so that the Company would be given a retroactive exemption as of January 2004 from the obligation to pay royalties for its revenues from services opened to competition.

On March 20, 2007, a draft amendment to the Royalties Regulations was sent out to the general licensees, as sent to the Minister of Finance for the purpose of obtaining his consent. The draft added a section exempting a domestic carrier from paying royalties for income from the provision of data communication services, management of a data communications network and PTP lines at high baud rates and certain types of links, where one of the parties is a corporation, as of January 1, 2004. Likewise, the amendment contains a provision regarding deduction of revenues and payments from the basis of royalty-attracting revenues, under which a licensee is not entitled to deduct an income component if such component is not included in the calculation of royalty attracting revenues, and the licensee is not entitled to deduct payments unless they are not ascribed to income included in the calculation of royalty attracting revenues. The amendment also contains an exemption from payment of royalties for the revenues of international carriers from data communications services, the duty to pay arrearage interest in the event of consolidation, and an amendment of the definition of "licensee" so as to include a broadcast licensee, in order to enable a domestic carrier to deduct its revenues from the provision of transmission services, even when the service is provided to a broadcast licensee.

The Economic Policy Law, published on April 11, 2005, imposes license fees and royalties to the collection of fees under the Communications Law and The Wireless Telegraphy Ordinance (New Version) 5732-1972 (hereinafter: the "Telegraphy Ordinance") and the Tax

Ordinance (Collection) 1929. The significance of the amendment 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 Communications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law. Until the Law was amended in 2001, this Chapter did not distinguish between public and private land, and enabled the Company and the persons it authorized for purposes of providing telecommunications services, to enter any real estate in order to carry out surveys and examinations required for planning a telecommunication installation, and for examining, repairing or making changes thereto or therein. In most cases, prior notice was required to be given to the occupier of the real estate and the latter could appeal to the Court.

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

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

2.16.5 Immunities

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

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

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

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

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

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

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

Under Section 13 of the Law which relates to the provision of telecommunications services to the security forces, a licensee or any of its employees shall bear no criminal or civil liability for any act committed in the performance of a direction to be given according to said Section, except in circumstances in which the State employee bore liability for the act. (Under the Civil Wrongs Ordinance, in any action other than negligence, a public servant

will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority).

2.16.6 <u>Regulations and rules under the Communications Law</u>

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

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

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

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

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

The Company acts to locate debtors and to collect debts from its customers. In cases where debts are not paid, legal action is usually taken through external lawyers. In cases such as when it is not financially feasible the debt is written off.

According to the regulations, the Company may disconnect a line if the bill in respect thereof is not paid within 21 days of the payment date prescribed in the bill, and discontinue the service if prior written notice thereof has been given.

On November 22, 2004, draft regulations were submitted for the review of the Company, HOT, and cellular license holders. These were for the establishment of a committee made up of representatives of the public to examine requests for exemption or exception from the provisions stipulated in the regulations or in the general licenses for the provision of services by the Licensee to the entire public. The Company submitted its response to the Ministry and, among other things, requested that an exemption or exception based on the existence of available alternatives in a region for provision of service be subject to the obligation of the Licensee whose request was successful to participate in the costs of financing of a Licensee that provides services in that region. As at the date of publication of this periodic report, to the best of the Company’s knowledge, there has been no progress in this regard.

2.16.7 <u>Antitrust laws</u>

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. Subsequently, the Company consented, at the suggestion of the court (in view of the time elapsed since the appeal, with an accompanying economic opinion, was filed), to withdraw the appeal, and it was struck out on August 2, 2006. In this regard, see also section 2.6.4 above.

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

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

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

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

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

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

F. In May 2006, the Antitrust Authority wrote to the Company regarding complaints from particular communications carriers regarding acts done, prima facie, by the Company to such carriers, and a complaint of one of the carriers received from the Ministry of Communications. According to such carriers, the aforesaid acts amount to abuse of the Company’s monopolistic power. The Company was required to provide the Authority and the Ministry with data and response to the questions set out in the letter, and it provided the requested information.

G. For the search performed at the Company’s offices on May 23, 2006, and the interrogation of a number of the Company’s employees regarding a suspicion of abuse of monopoly status and/or unreasonable refusal to provide an asset or a service in a monopoly, and for other searches and the interrogation of a number of other employees of the Company (including office-bearers) conducted pursuant to such, see Note 17C to the financial statements of the Company for the period ended December 31, 2006.

H. For the Commissioner’s objection to the merger of the Company and DBS, see section 1.1.5 above.

The Company has adopted an internal compliance policy (hereinafter: the "Policy") containing internal reporting and internal procedures which essentially ensured that the activity of the Company and its employees would be carried out in accordance with the provisions of the Antitrust Law, 5748-1988 (hereinafter: the "Antitrust Law"). The Policy includes a general explanation regarding the Antitrust Law, guidelines for the Company's and its employees' conduct so as not to breach the provisions of the Antitrust Law. Under the Policy, the internal compliance officer issues, from time to time, general and specific directives on various issues (such as pricing, relations with subsidiaries, contacts with customers and the like). The internal compliance officer's directives bind all of the Company's employees and managers.

2.16.8 The Wireless Telegraphy Ordinance

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

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

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

The Company and the Ministry of Communications have a number of differences of opinion regarding fees which the Company claims it does not owe and therefore has not paid. As at the date of this periodic report, the disputed amounts are approximately NIS 42 million.

2.16.9 Proposed legislation regarding termination of contractual relations

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

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

During the last quarter of 2006, the form of the bill in this regard was once again brought up for discussion in the Economics Committee of the Knesset. Only some of the sections of the bill were voted on. The Company sent its comments to the Committee's legal counsel.

With respect to the hearing for general licensees regarding the intention to regulate a similar issue – the "fixed transaction" issue – via the licenses, see section 2.16.2 above.

2.16.10 The Class Actions Law

On March 12, 2006, a new Class Actions Law was published under which class actions may be filed under a variety of causes of action that are set out in the Schedule to the Law, and under express statutory provisions regarding class actions (detailed provisions in, among others, the Antitrust Law, the Consumer Protection Law, the Banking Law were repealed). Under the Law, the provisions of it shall also apply to applications and actions that are pending in court on the date of publication of the Law. The Law defined and extended the persons who may submit class action applications, and set out the conditions for submission. The Law gives the Court discretion in various matters such as compensation, remedies, substitution of representative plaintiff and restriction on approval of claim against an entity providing an essential service to the public. The Law provides stringent rules regarding the striking out of applications and regarding settlements which require, *inter alia*, the consent of the Court. The Law sets up a fund for the financing of class actions, the role of which is to assist representative plaintiffs in financing applications the submission of which is of public and social importance.

2.16.11 Establishment of communications installations - National Outline Plan 36

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

B. NOP 36A

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

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

As of the date of this periodic report, the Company has submitted 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 and building permits have been issued for most of the small broadcasting installations in accordance with NOP 36A. The Company is dealing with obtaining the permits from the relevant licensing authorities for the remaining 14 small broadcasting installations. Due to intensive activities being done at the Company regarding the obtaining of permits, and due to the termination of operation of certain installations, the number and class of sites change from time to time.

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

C. NOP 36B

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

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

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

NOP 36B further proposes to include a provision according to which a building permit will not be granted according to Chapters C and D of the Plan, unless the applicant for the permit has submitted a letter of indemnity for compensation under Section 197 of

the Planning and Building Law, should a judgment go against the local committee. The Company has submitted its objection to the inclusion of said provision in NOP 36B.

The Company is working with the Ministry of the Interior and the Ministry of the Environment with respect to the entry into force of NOP 36B which deals with building permits for the large broadcast installations.

D. General

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

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

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

2.16.12 Bill to amend Section 13 of the Communications Law

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

On September 11, 2006, another amended form of the bill was sent to the general licensees, in view of a discussion that was subsequently held in the Economics Committee of the Knesset. A provision was added in the amendment, granting jurisdiction to the Ministry of Communications to give instructions to licensees in the event of a significant malfunction or stoppage in the provision of a telecommunications service and in the provision of broadcasting, other than under emergency circumstances. At the above discussion in the Economics Committee of the Knesset, it was argued that this provision amounts to a "new topic". Therefore, sections of the bill were not discussed in the Economics Committee. The Company's position paper on the proposed addition makes it clear that the provision that was added is unreasonable, and that it is unjustified in general, and in particular in the context of this statutory amendment, because extending the application of provisions dealing with emergencies to matters that relate to relationships between carriers is not proportionate, and does not comply with the Basic Laws test. The bill that included the new provision was brought up for discussion, was discussed, and votes were held on the discussion in the Economics Committee of the Knesset.

2.16.13 Restrictions and supervision of the Company's operations regarding the Government decision on proposals to amend the Communications Law under the "Arrangements Law"

In September 2006, the Government decided to approve the decision of the Ministerial Committee on Socio-Economic Affairs to amend the Communications Law with respect to the imposition of monetary sanctions on a licensee, inter alia, such that the sum of the monetary sanction which may be imposed for breach of a provision of the license or of certain provisions of the Communications Law, will be increased with respect to a licensee whose revenues during the financial year preceding the breach are greater than NIS 100 million, from twenty-five times the amount of the fine set out in section 61(a)(1) of the Penal Law, 5737-1977 to seven times the amount of the fine set out in section 61(a)(4) of the

Penal Law (approximately NIS 1,400,000), plus 0.25% of the revenues of the licensee in the financial year preceding the date of the breach (meaning, for the Company, approximately NIS 12,000,000 in 2005 terms, in addition to the above sum). The Director General of the Ministry shall be entitled to reduce the rate of the sanction in circumstances where the licensee or the permit holder cooperates with the Director General in disclosing all information and/or takes steps to reduce or terminate the breach up to a deduction of 15% for each cause of action.

Likewise, the Government decided to amend section 5 of the Communications Law and add a provision whereby if the Minister is of the opinion that such is necessary in order to set-up infrastructure for radio broadcasts using the digital method, under the Second Radio and Television Authority Law, 5750-1990, and there being no other reasonable alternative to setting up such infrastructure, the Minister may give an instruction to a general licensee that use will be made of its installations in order to set up such infrastructure, in consideration for such payment as may be prescribed.

The Company's position is that in addition to arguments relating to the main body of these proposals, the Arrangements Law cannot be used as a half-way house for these kinds of amendments, since they are provisions with serious and substantial consequences, including penal provisions and provisions that harm the Company's property.

On January 11, 2007, an amendment to the Communications Law was published under the Arrangements Law which contained provisions regarding the expansion of the monetary sanctions, *inter alia*. Section 5 has been split from the Bill and is not included in the form of the amendment that was passed.

2.17 Substantial agreements

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

2.17.1 Debentures

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

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

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

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

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

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

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

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

2.17.2 Real Estate

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

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

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

See Section 2.7.4C above.

C. Agreement between the Company and the Israel Postal Authority

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

2.17.3 Various agreements with DBS and its other shareholders

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

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

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

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

2.17.4 Labor agreements

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

The agreement provided a full and autonomous arrangement regarding the pension insurance of Company employees. The agreement applies to all transferred

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

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

For information on this, and regarding early retirement, see Note 16 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

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

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

In this regard see also section 2.9.5 above.

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

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

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

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

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

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

In this regard, see also Note 16(g) to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

F. New special collective agreement dated December 5, 2006

A collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company (see section 2.9.1 above).

Under the agreement, all agreements, arrangements and procedures existing in the Company prior to execution of the agreement, including the mechanism of linkage of salaries to the public sector, shall continue to apply to permanent, senior employees of the Company only, to whom the agreement applies, subject to amendments made expressly in the Agreement. Existing and new temporary employees shall be employed on the basis of monthly / hourly salary agreements that are based on a market salary model according to their businesses, with a high level of administrative flexibility.

The agreement also provides that in 2006-2008, 975 permanent employees shall retire from the Company under early pension schemes or increased severance pay schemes. The Company shall also be entitled, at its discretion, to terminate the employment of a further 1225 permanent employees (245 permanent employees during any one or more of the years 2009-2013). The retirement conditions to be offered to the retirees shall be identical, for the most part, to the retirement conditions employed at the Company at present.

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

2.17.5 Management Agreement

On March 23, 2006, the general meeting of the shareholders of the Company approved entry by the Company into an agreement with a company which is to be owned and controlled by the shareholders of Ap. Sab. Ar. under which the Company shall be given ongoing management and consultancy services, including via directors who may act from time to time in the Company and/or its subsidiaries, all in return for USD 1.2 million each year. The term of the contract is from October 11, 2005 (the date of completion of acquisition of 30% of the shares of the Company by Ap. Sab. Ar.) and until December 31, 2008, unless one of the parties gives notice to the other of its desire to terminate the contract by way of prior notice of three months in advance.

2.18 Legal proceedings

For information on legal proceedings see Notes 15, 16 and 17 to the financial statements for the year ending December 31, 2006, included in this periodic report, and sections 1.1.5, 2.6.1 and 2.6.6 above.

2.19 Goals and Business Strategy

2.19.1 Forward-looking information

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

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

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

marketing strategy by competitors. Furthermore, a change in the ownership of the Company may also lead to changes in its strategy and business objectives.

2.19.2 Summary of strategy and future plans

At the Group level

As at the date of publication of this periodic report, the Company is acting, upon consultation with an international consultancy firm, to formulate its strategy as a communications group for the coming years.

At the Company Level

The Company is operating to implement a strategy of going from a company that provides infrastructure only, to a company that provisions a variety of products and services that are tailored for customers' needs.

Vision and objectives

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

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

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

B. Reducing the decline in revenues from core services;

C. Generating new sources of revenue;

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

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

Business customers

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

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

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

D. Offering a variety of value-added services.

Private customers

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

B. Providing differential pricing tracks;

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

Network

In order to attain its strategic goals, the Company is acting with respect to improvement of its network and tailoring it to its commercial targets, as follows:

A. The Company is examining the issue of deployment of a new-generation switching network (NGN), which will allow it to launch new services with a shorter time to market, simplify the structure of the network, reduce maintenance and operation costs, and leverage real estate potential (see also section 2.6.7 above).

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

Organizational restructuring and implementation at the Company

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

2.19.3 Development trends in Company activities

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

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

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

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

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

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

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

2.19.4 Main projects being planned or currently being implemented

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

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

A. On December 5, 2006, a new special collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd., and prescribing a new organizational structure for the Company. For this, see sections 2.9 and 2.17.4 above.

B. On March 29, 2007, the board of directors of the Company resolved to appoint Adv. Dr. Yoram Danziger to the post of external examiner regarding matters arising out of immediate reports given by the Company on March 20, 2007 regarding the approval of an option plan for employees and managers, an immediate report given by the Company on March 26, 2007 regarding grants to office bearers and an immediate report given by the Company on March 26, 2007 regarding presentation anew, in accordance with the provisions of the letters from the Securities Authority to the Company dated March 25, 2007 and March 28, 2007. The external

examiner, who shall commence work on April 1, 2007, shall be required to submit his interim findings to the board of directors of the Company and to the Securities Authority no later than April 12, 2007, and his final findings by April 26, 2007.

For the removal of any suspicion, and if only for the sake of appearances, with respect to the external examiner's full freedom of operation and access to all material at the Company as he may see fit, the CEO of the Company, Mr. Yacov Gelbard, asked for the consent of the board of directors to permitting him to take leave of absence until the date of submission of the interim findings by the examiner, as set out above. The board of directors of the Company accepted Mr. Gelbard's request and resolved that during the period of Mr. Gelbard's absence, Mr. Yitzhak (Ika) Abarbanel, currently the deputy CEO of the Company, will act in place of Mr. Gelbard, as substitute CEO of the Company.

2.21 Risk factors

A. Increasing competition

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

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

The possibility of providing telephony services over the Company's and HOT's broadband infrastructure (VOB) and number portability could also contribute to increased competition.

B. Government supervision and regulation

The Company is subject to government supervision and regulation that, among other things, relate to licensing for activity, determining permitted areas of activity, operation, competition, payment of royalties, obligation to provide universal service, determining tariffs, ability to hold its shares, relationships between the Company and its subsidiaries and prohibition to terminate or restrict its services (which may force the Company to provide services even when not economically feasible or when it goes against its interests). Said supervision and regulation at times lead to State intervention, which the Company believes adversely affects 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 Supervision of Prices for Commodities and Services Law. Furthermore, the bureaucracy involved in setting "tariff baskets" for the sale of service packages by the Company delays the time to market of the tariff baskets, affecting the Company's ability to compete.

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

D. Difficulties in labor relations and human resources

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

Labor relations at the Company have, over the years, seen ups and downs, but in management's opinion, following execution of the new collective agreement and the change in the organizational structure, labor relations are now expected to be quieter and more stable than in the past.

E. Restrictions upon entry into new services

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. Restrictions on relations between the Company and companies in the Bezeq Group

The Company's general license obligates it to ensure that its relationship with its principal subsidiaries in the Bezeq Group does not cause them to be preferred over their competitors. Under the general license, separation is required between the respective managements of the Company and said companies, and separation is also required in the financial and marketing systems, as well as assets and employees, which causes high administration overheads. The Company is also not allowed, at this stage, to offer joint service bundles with the aforesaid companies. In light of the development of communications groups in the field which are not subject to such restrictions on joint operations, the extent to which this risk factor might affect the Company's operations has increased as the competition has developed.

G. Legal proceedings

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

Class-action claims can reach large amounts, as virtually all residents of the country are consumers of the Company's services, and a claim that relates to minor injury to a single consumer may become a significant case for the Company if it is recognized as a class action that applies to all consumers or a significant portion of consumers. Additionally, as the Company provides communications infrastructures as well as billing and collection services to other Licensees, parties initiating legal action against said Licensees in other class action cases may even try to involve Company as a party to these proceedings (for the legislative proceedings regarding class actions see section 2.16.10 above).

For a description of the legal proceedings, see section 2.18 above, which refers, inter alia, to Note 17 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

H. Exposure to exchange rate fluctuations and inflation

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

I. Electromagnetic radiation and licensing of broadcast installations

The issue of electromagnetic radiation emitted from broadcast facilities is regulated mainly in the Non-Ionized Radiation Law, 5766-2006, and in the Pharmacists Regulations, and the issue of licensing is governed by NOP 36 (see sections 2.15 and 2.16).

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

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

J. Frequent Technological Changes

The communications field is characterized by frequent technological changes and a shortening of the economic life-span of new technologies. These trends mean a lowering of entry barriers for new competitors, an increase in depreciation rates and in certain cases, redundancy of technology and networks owned by the Company, the cost of investment in which may still be recorded on its balance sheets.

Risk Factor Summary Table

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

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

3.1 General Information on Area of Operations

3.1.1 Pelephone's field of activity

Four companies operate in Israel's cellular communications market. Activity in the mobile radiotelephone sector ("**MRT**" or "**Cellular Communications**") began with the incorporation of Pelephone in 1985. Pelephone deals in the provision of cellular communications services, and sale and repair of terminal equipment. Pelephone's revenues include, inter alia, the charging for MRT communications customers (payments for call minutes, regular subscriptions, added value services and migration services, payment for the sale of terminal equipment and in respect of terminal equipment services) and revenues from other communications providers for interconnect (see sub-paragraph 3.2 below).

As of August 2004, Pelephone is wholly owned by Bezeq.

3.1.2 Legislative and secondary legislation restrictions applicable to Pelephone

3.1.2.1 General license

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Services, which is valid until 2022 (hereafter: "**the license**"). The license prescribes conditions and rules that apply to Pelephone's operations, and the competent authorities may amend the licensing conditions subject to the law.

3.1.2.2 Tariff control

The tariffs that Pelephone is permitted to collect from its subscribers are regulated by its license with the exception of the call completion and SMS tariffs, which are regulated under regulations as of October 2000. In December 2004, the Telecommunications (Telecommunications and Broadcasts) (Payments for Interconnect) Regulations, 5760-2000, were amended in such a way as to reduce tariffs for interconnect to the MRT network regarding call completion, transmission of SMS messages and to modify the method of calculating the duration of chargeable time beginning in 2009 (see sub-paragraph 3.18.2).

3.1.2.3 Royalties

Under its license and under the Telecommunications (Royalties) Regulations 5761-2001, Pelephone pays the State of Israel royalties out of its revenues which bear royalties due to the provision of telecommunications services (see section 3.18.3.2 below).

3.1.2.4 Environmental matters

The laying of the wireless infrastructure including cellular communications 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 and profitability in the field

The following are financial and quantitative data regarding Pelephone scope of operations and profits for 2005-2006:

	2006	2005
Revenues (NIS millions)	4,478	4,428
Operating profit (EBIT) (NIS millions)	700	591
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	1,171	1,021
Number of subscribers at end of period[16] (in thousands)	2,427	2,287
Average minutes of use (MOU)[17] per subscriber per month	349	338
Average monthly revenue per subscriber (NIS) (ARPU)[18]	138	138

3.1.4 Market development and changes in customer attributes

In recent years, the cellular market has been characterized by lower growth rates than in the past due to saturation of penetration rates. The competition's focus on increasing growth rates encourages the companies in the field to increase their segmentation and to make special offers to various target groups, providing specific responses to their needs.

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

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

A. The CDMA track, which developed in the 2.5 generation to 1X and in third generation to EVDO (hereinafter: "CDMA Technology") – Pelephone's network operations using this technology.

B. The GSM track, which developed in the 2.5 generation to GPRS and in the third generation to UMTS / HSDPA, and in the 3.5 generation to HSUPA (hereinafter: "UMTS Technology") – the networks of Pelephone's principal competitors in Israel use this technology.

3.1.5.2 In 2004 Pelephone launched 3rd generation services in Central Israel by means of CDMA 2000 EVDO which connects up to CDMA 2000 1XRTT technology that is deployed throughout the country. The EVDO network was deployed in urban areas during 2004-2006 (for details see section 3.9 below). 3rd generation services to enable transfer of data, including video, in larger files and enables Pelephone to offer its customers a wide range of added value services (for details see section 3.2.1 below).

3.1.5.3 Pelephone has the right to receive allocation of frequencies in ranges of 2000MHZ that can be used by Pelephone for UMTS technology. 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 3.25.2.5) and will enable use of standard terminal equipment supporting UMTS technology which will permit the reduction of prices of terminal equipment and extension of roaming services (see section 3.2.1). At the end of 2006, the board of directors of Pelephone resolved to allow management of Pelephone to take steps to examine the setting up of another network using UMTS technology, including support of HSDPA / HSUPA technology. In addition, initial preparations and investments for setting up this network have been approved. At the beginning of March 2007, the RFP to set up the new network was distributed to infrastructure suppliers. Setting up of this network is subject to the approval of Pelephone's authorized bodies.

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

17 MOU (Minutes Of Use) – average monthly minute use per subscriber. This index is calculated in accordance with an annual average of the sum total of outgoing and incoming minutes each month, divided by the average number of subscribers during that month.

18 ARPU (Average Revenue Per User). This index is calculated by averaging the division of total revenue from cellular services and repairs each month by the average number of subscribers in that month.

3.1.6 Critical success factors and the changes commencing therein

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

- National deployment of a high-quality, advanced MRT network, ongoing maintenance of the network at a high level and significant investments, on an ongoing basis, in cellular infrastructure, for the purpose of improving high-quality coverage around the country, which is a basic condition for the provision of Pelephone's services, and in order to provide customers with the most advanced services, via the most advanced technological infrastructure.
- Provision of high-quality call services and advanced added value services.
- National deployment of service and sale centers which enable high quality customer support and service which allows the company to successfully deal with a competitive market.
- Professional, high-quality, human resources.
- Marketing strategy for grounding and reinforcing the brand name.

3.1.7 Principal entry and exit barriers

The principal barriers to entry to the area of operations are:

- the need for a MRT license, the allocation of frequencies, and operations being subject to the regulatory supervision that applies to the market (see section 3.18 below).
- the need for significant financial resources for making serious investments in infrastructure, which are affected by frequent technological changes, and the importance of providing a response to the needs of the market.
- The difficulty involved in setting up radio sites due to regulatory restrictions and public objections.

It is important to note that the investment barriers do not apply to any potential virtual carrier (see section 3.7.2 below).

The principal barriers to exit from the area of operations are:

- Long-term agreements with infrastructure suppliers and property owners with whom Pelephone has entered into lease agreements.
- Large investments which require long periods to recoup investments.
- The obligation to provide services to customers in accordance with conditions prescribed in the license.

3.1.8 Substitutes for Pelephone products

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

Telephony services based on VOIP/VOB technology might constitute a substitute for cellular services in areas where the local wireless networks have coverage.

3.1.9 Structure of competition in the sector and changes therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of Bezeq's license and on its behalf[19]). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (hereafter: "**the second operator"** or **"Cellcom").** In February 1998**,** a third operator was selected by invitation to tender – namely Partner Communications Ltd. (**hereafter:** "the third operator" or "Partner"). As of February 2001, MIRS Communications Ltd., (hereafter: "**MIRS")** has been operating as an additional cellular operator. After the entry of the second operator, and later, the third operator, into the cellular market, fierce competition developed among the carriers (primarily between the three main carriers). This competition resulted in

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[19] Bezeq's license was in fact amended in April 1994, when it was prohibited from supplying a cellular service. A general license was in fact granted to Pelephone in February 1996, which had retroactive application back to 1994.

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 section 3.7 below).

3.2 Products and Services

3.2.1 Services

Pelephone provides its subscribers with comprehensive services of voice transmission, data communications and advanced multimedia services as follows:

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

Advanced services (hereinafter: "added value services") - the subscriber may purchase added value services such as text message services and information services using SMS, multimedia MMS messages, voice information services using special-purpose asterisks, information and entertainment services via the Internet portal and advanced content services such as JAVA games, network games and video games. Among other things, subscribers may choose animation items or different ring-tones from Pelephone's internet portal, and may download them to their handsets. Also, subscribers may receive services connected to their electronic diaries (Outlook services) enabling subscribers to obtain SMS messages regarding the arrival of e-mail messages, and to read and reply to them, all through their handsets. Moreover, using their handsets, subscribers can peruse and update their electronic diaries, and view their address list. Subscribers can also receive SMS notice of scheduled events in their electronic diaries.

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

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

3G services – Pelephone offers its customers services using third generation technology, including, *inter alia*, viewing its various television channels such as: Music, sport, news and a variety of entertainment channels, the ability to film and transfer video files, GPS cellular services, Navigator services, high-speed 2.4 MBPS cellular modem.

At present, some 350,000 subscribers have handsets which enable use of third generation services.

Roaming services – Pelephone provides roaming services (communications via MRT from various locations worldwide), in accordance with agreements that it has with cellular providers around the world. In order to facilitate similar services in Europe and in other countries where the network is not based on CDMA technology, Pelephone leases handsets to its customers that are adapted to the technology in use in those countries, in accordance with agreements between Pelephone and cellular operators in those countries. Pelephone has a series of agreements which enable its customers to receive services in 208 countries around the world. During 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets provide an additional solution to roaming services in other countries where the network is not CDMA. In light of the lack of a variety of handsets and support of some of the handsets that Pelephone provides its customers, this solution is a partial solution only and does not address all marketing needs.

During 2006, Pelephone signed agreements with two GSM carriers, which expands its ability to provide its customers with roaming services around the world. These agreements enable Pelephone to provide its customers with broader and more varied roaming services. At the end of 2006, Pelephone was getting ready to support data transfer services under roaming, in addition to its existing support of call and sms services on GSM networks.

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

3.2.2 Products

Terminal handsets – Pelephone offers its customers various kinds of mobile telephone handsets, vehicle handsets, hands-free sets and assorted accessories which support the variety of services that it provides.

3.3 Segmentation of Revenues and Profitability from Products and Services

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

	2006		2005	
	NIS millions	% of revenues	NIS millions	% of revenues
Revenues from cellular and terminal equipment services	3,861	86%	3,704	84%
Revenues from the sale of terminal equipment	617	14%	724	16%
Total	4,478	100%	4,428	100%
Percentage of gross profit	27%		25%	

3.4 New Products

In 2006, Pelephone expanded its added value services, and launched new services, as follows:

- Advanced road services including: Voice navigation services, speed traps warnings, fast lane location and traffic reports.
- Navigation services via the handset, using map-based GPS.
- Back-up of telephone book on network.

3.5 Accounts Receivable

As at the end of 2006, Pelephone had 2.427 million subscribers. 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 40 sales and service centers and laboratories around the country, which deal in service and sale to customers, treatment of malfunctions, installation of handsets, and service and sales personnel and independent resellers spread out in 81 points of sale (some of which are operated by Pelephone employees, and others of which are operated by the independent resellers). In addition, service and sales representatives also serve the business sector.

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

3.7 Competition

3.7.1 Pelephone faces fierce competition from the other cellular operators: Partner, Cellcom and MIRS. This competition brought about an increase in the size of the market, the addition of new subscribers and an erosion of prices. The competition is expected to increase as a result of the entry of number portability into force (see section 3.7.3 below).

To the best of Pelephone's knowledge from the data published by each of the cellular companies in Israel, as at the end of 2006, there are approximately 8.3 million cellular subscribers in Israel: Pelephone has approximately 2.4 million subscribers, Cellcom

reported approximately 2.8 million subscribers, Partner reported approximately 2.7 million subscribers and Mirs, approximately 0.4 million subscribers[20].

3.7.2 In September 2006, the Government approved a decision under which the Ministries of Finance and Communications were required to examine the issue of the operations of virtual providers in Israel in the field of mobile telephony, and to formulate, if necessary, a model for encouraging the operations of virtual carriers in Israel by May 1, 2007. A mobile virtual network operator (MVNO) is a cellular operate which purchases airtime from an ordinary cellular operator (which owns infrastructure) via a commercial contract. The MVNO uses existing cellular networks and sells its services to the public under a separate brand name. In January 2007, the Ministry of Communications published an RFP for consultancy services in order to formulate its position regarding the operations of an MVNO in Israel. By May 2007, prior to making a final decision on the matter, the Ministry is expected to hold a hearing for carriers in order to find out their position on the entry of an MVNO into the cellular industry in Israel. Pelephone's position is that in any event, there is no room for regulatory impositions in this area, and the company is getting ready to present this position to the Ministry of Communications, the Ministry of Finance and other relevant regulatory bodies.

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

On August 23, 2006, the Ministers of Communications and Finance announced that implementation of the plan would not be postponed beyond September 1, 2006. The Ministers' notice also stated that the Director General of the Ministry of Communications had recommended that if the plan is not implemented and operated by that date, "the relevant communications companies would be declared in violation of the law, with everything that entails". Following this decision, both Pelephone (together with the other cellular companies) and Bezeq filed petitions in the High Court of Justice for a decree nisi against the Government of Israel and the Minister of Communications. The petitioners allege, *inter alia*, that even though they had worked assiduously for implementation of the plan, investing considerable resources for the purpose, they are unable to meet the unrealistic timetables set in the law for its implementation. The petitioners further alleged that the Ministry of Communications had failed to prepare a number portability plan and had not prescribed a structure for the payments that would apply among the operators, as the Law requires. At this stage, Pelephone is unable to assess the consequences of the above. In a preliminary response by the State to the petition, the State dismisses the claims raised by the petitioners, and places the responsibility for non-compliance with the regulating provisions of the law on the communications companies.

Pelephone has progressed in its preparations for activating number portability, and it assesses that it will be able to commence testing with other companies on April 1, 2007. The testing process with the other carriers is estimated to take approximately 4-5 months, and will be conducted via a consultancy firm which has been chosen. After completion of the tests between the carriers, a test needs to be performed on a sample group of customers before full activation of number portability, and that test is expected to last about one month. On February 15, 2007, the Ministry of Communications wrote to the carriers

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

requesting information on the status of their preparations for number portability, based on the Ministry's intention to rewrite the timetable for implementation of the number portability plan.

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

Bezeq's license imposes restrictions on it in all matters pertaining to cooperation with its subsidiaries. In the opinion of Pelephone and Bezeq, to the extent that these restrictions remain in force, without, at the same time, similar restrictions being imposed on the competing MRT operators, they will adversely affect Pelephone's ability to compete with its rivals in the industry. For the restrictions imposed on Bezeq and Pelephone by virtue of the merger conditions, see section 3.18.3 below.

During the last quarter of 2006, the Ministry of Communications has been holding a renewed hearing on the matter of final formulation of its policy regarding licensing of the supply of telephony services using broadband access (VOB). On February 1, 2007, the Ministry published its final policy document on VOB in which it prescribed that Bezeq and the companies in the Bezeq Group (including Pelephone) shall be entitled to take part in this industry only once Bezeq's market share of the domestic fixed line telephony industry falls to below a threshold of 85%. Pelephone objects to this policy and is of the opinion that it should be treated as an independent body, due also to the existence of the restrictions imposed upon it regarding joint marketing and the sale of joint bundles with Bezeq. Pelephone expressed its opinion during the hearing before the Ministry of Communications and is looking into its steps following publication of the Ministry's policy.

In August 2006, Pelephone Fixed Line Communications Partnership, which is a limited partnership that is wholly owned by Pelephone and is a subsidiary of it, submitted an application for a special general license to provide domestic fixed line telecommunications services. As part of the Ministry of Communications' policy in the area of VOB, it has determined that a response to this application shall be given separately. As at the date of the report, no response has been received.

3.7.5 Positive and negative factors affecting Pelephone's competitive position

Positive factors:

A The advanced thirrd 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. Service system and range of customer service interfaces enabling the provision of high-level service to customers.

D. An extensive distribution system specializing in the provision of solutions appropriate to each type of customer, and high-quality human resources.

E. Strong capital structure and positive cash flow.

Negative factors:

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

B There are restrictions on joint activity with Bezeq, including in the marketing of joint service bundles.

C. CDMA technology does not enable the provision of roaming services in the same manner as this service is provided by competitors, as this technology is less common around the world.

D. Two of the leading terminal equipment manufacturers in the world in this industry do not manufacture cellular telephones using CDMA technology for the Israeli market.

3.8 Seasonality

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

3.9 Property Plant & Equipment

Pelephone's fixed assets include the infrastructure equipment of the network core, radio sites, electronic equipment, computers and software systems, motor vehicles, terminal equipment, office furniture and equipment and leasehold improvements.

3.9.1 Infrastructure

3.9.1.1 Pelephone's infrastructure investments

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

3.9.1.2 Pelephone operates two communications networks using three technologies:

A Digital technology using CDMA2000 1XRTT. This is a state-of-the-art technology and its advantages are the ability to provide advanced services, greater capacity for talk calls and data for a given quantity of frequencies and fast data communications (up to 144KB).

B Digital technology using the EVDO method – see section 3.9.1.6 below.

C. Analog technology using the NAMPS (Narrow Band Advanced Mobile Phone System). This is old technology which is not undergoing network development processes, and at present, traffic over it is negligible.

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

3.9.1.3 As at the date of publication of the report, Pelephone's MRT infrastructure (CDMA) is based primarily on 8 digital switches manufactured by Nortel, connected to approximately 1,435 radio sites (cells), in a countrywide spread. Each radio site incorporates an antenna for reception and transmission and a computerized control system, and covers a certain geographic area. The cells are connected to base station controls (BSC) that are hooked up to the switches. The switches are connected to one another and to all the other telecommunications operators (Bezeq, Partner, Cellcom, MIRS, HOT, and international operators).

3.9.1.4 The depreciation period for site equipment is up to 10 years. Depreciation for switching equipment is between 5 and 7 years. The depreciation period of the equipment is determined on the basis of engineering opinions based, inter alia, on generally accepted practice in various other countries.

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

3.9.1.6 As of 2004, the Pelephone Board of Directors began upgrading the CDMA2000 1XRTT network to EVDO technology by means of the addition of a special–purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the terminal

equipment at rates of up to 2,400 KSS (downlink) and between the terminal equipment and the network at rate of up to 144 KSS (uplink). The EVDO equipment is manufactured by Nortel. Parallel to setting up the network, a portal was set up for video services enabling customers to view live broadcast channels, to download music clips, entertainment, news, etc. This portal is the key service using EVDO technology. This portal was extended to support dozens of video channels during 2006.

3.9.1.7 In 2005, Pelephone acquired equipment from Nortel, in a long-term transaction for 2005-2007, for the expansion of its network, including 150 sites and equipment to upgrade the capacity of the network. The value of the transaction was approximately $ 20 million. Pelephone has not yet exercised the whole of this undertaking.

3.9.2 <u>Premises used by Pelephone</u>

Pelephone is not the owner of any land, and it leases the premises which it uses for its operations from others, including Bezeq. The following is a description of the main premises used by Pelephone:

3.9.2.1 The land which Pelephone uses for installation of radio and switching sites, as set out in section 3.9.1.3, are spread out around the country, and are leased for various periods (in many cases, for 5 years plus an option to extend the agreement for another 5 years). For site licensing, see section 3.18.3.3 below.

3.9.2.2 Pelephone's head offices have been in Givatayim since 1997, and cover a total area of 17,000 sqm. In 2006, Pelephone signed an agreement to extend the lease term until December 31, 2010.

3.9.2.3 For the purpose of service and sale operations, Pelephone leases 40 service and sale centers, and 51 points of sale spread out around the country.

3.9.2.4 Pelephone has additional lease agreements with respect to warehouses, offices and telephone call centers which it uses for the purpose of its operations.

3.10 Intangible assets

3.10.1 <u>MRT license</u>

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

3.10.2 <u>Frequency usage right</u>

Pelephone uses frequencies in the 800 MHZ range, granted to it by virtue of its license. These frequencies are used by Pelephone mainly for CDMA2000 1XRTT technology and EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2000 MHZ ranges) using UMTS technology. In this regard, see Note 18 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

3.10.3 <u>Trademarks</u>

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

3.10.4 <u>Customer Base</u>

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

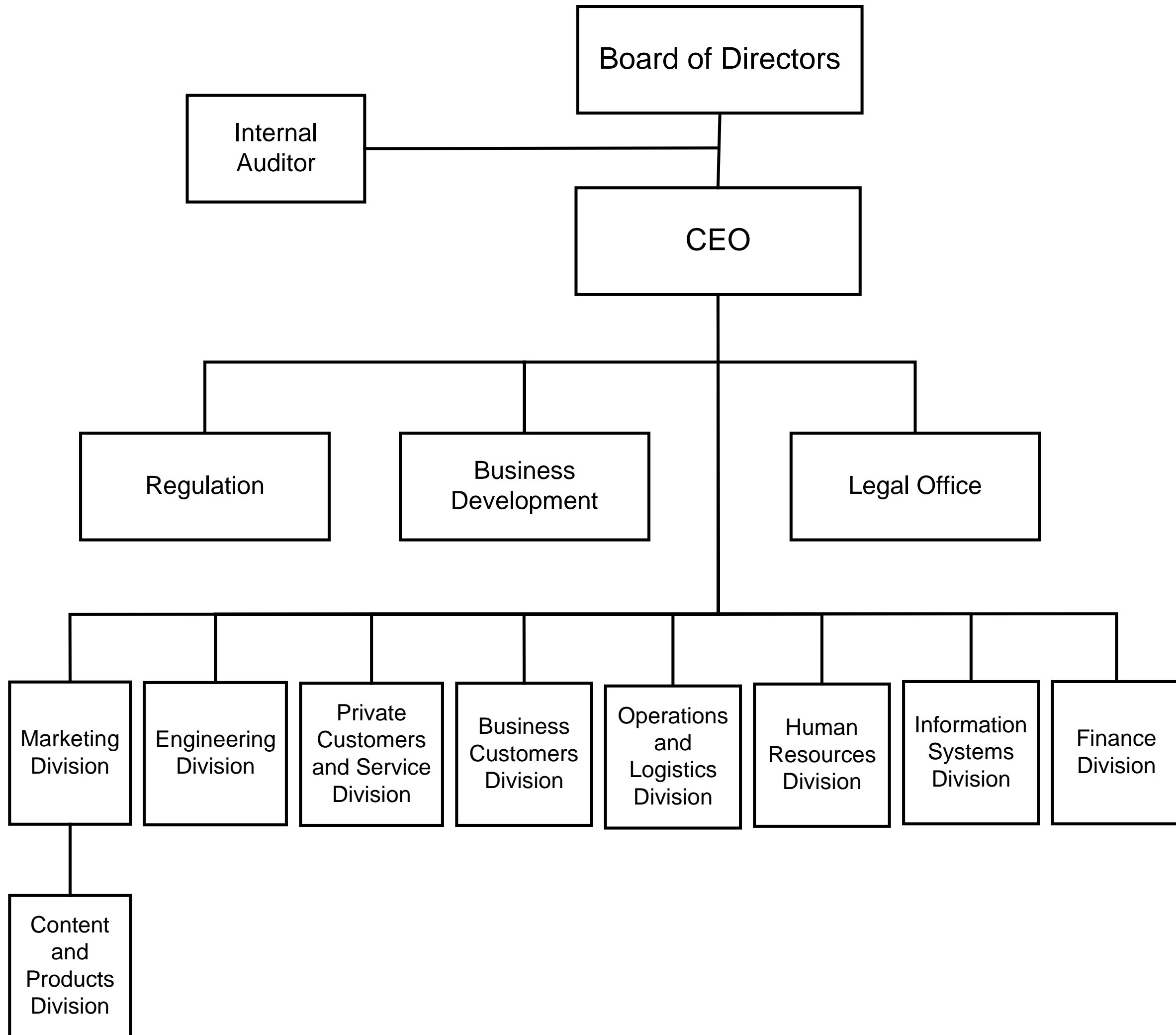
3.10.5 <u>Software, computer systems and databases</u>

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

3.11 Human Resources

3.11.1 Organizational structure

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



3.11.2 Table of organization

The following details the number of employees[21] in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.06	31.12.05*
Headquarters and management	290	258
Content marketing and products division	95	84
Customer Service and Private Sector Division	2,427	2,462
Business Division	438	390
Operations and Logistics Division	306	375
Engineering and Information Systems Division	593	571
Total	4,149	4,141

* Re-classified following transfer of operations between various Divisions.

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

3.11.3 <u>Changes in the number of employees during 2006</u>

At the end of 2006, Pelephone's manpower stands at approximately 4,149, compared with approximately 4,141 at the end of 2005.

3.11.4 <u>Instruction and training</u>

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 2006 and 2005 in respect of instruction and training amount to NIS 9.3 million and NIS 6.5 million, respectively. The employees who work as sales and service representatives and as telephone call center employees have a high churn rate, which requires constant investment in new employees.

3.11.5 <u>Employee and Manager Reward Schemes</u>

It is the practice of Pelephone to award its employees and managers grants and incentives on a monthly, quarterly and annual basis commensurate with their achievement of the targets set for them and in accordance with the type of work done by the employee.

3.11.6 <u>Employment contracts</u>

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

3.12 Products and Suppliers

3.12.1 <u>Terminal equipment suppliers</u>

The Pelephone products' inventory includes a range of cellular telephone units and a range of auxiliary accessories (such as: batteries, hands-free kits, earphones, data cables, chargers and so forth). Pelephone also maintains inventory of spare parts for the purpose of supplying repair services to its customers and an inventory of used handsets.

Pelephone purchases the terminal equipment and accessories from a variety of suppliers and importers in Israel. Contractual engagements with most of the suppliers are based on framework agreements setting forth, *inter alia,* the technical support provided by the supplier for the terminal equipment it supplies, the availability of the spare parts and the turnaround time for repairs. These agreements include a commitment to make acquisitions, which are implemented regularly by means of purchase orders.

If a contract with a particular terminal equipment supplier is discontinued, Pelephone may increase the quantity purchased from other terminal equipment suppliers or procure terminal equipment from a new terminal equipment supplier. If the replacement of a supplier is required, as aforementioned, the replacement shall not be immediate, and shall be subject to a special preparatory period for purchasing spare parts and accessories, including the repair capacity for all kinds of malfunctions, in order to enable the provision of service to customers as agreed. Replacement of a supplier will involve the addition of exceptional costs as a result of the need to purchase equipment, and will involve a period of re-organizing affairs with the replacement suppliers.

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

3.12.2 <u>Value Added Service Suppliers</u>

Pelephone has agreements with content suppliers under which Pelephone receives content such as information services by voice mail, SMS or via Pelephone's portal, games, animations, ring-tones, location services, content and the rights to broadcast over third generation technology. As is usual in this industry, a large portion of these agreements are based on a model of dividing revenues between Pelephone and the content suppliers for the services provided to customers. Termination of contracts with certain suppliers might cause delays in supplying some of the services pending contracting with substitute suppliers.

3.12.3 <u>Infrastructure Suppliers</u>

As set out in section 3.9.1 above, Pelephone's infrastructure equipment is manufactured by Nortel and Motorola. Pelephone has long-term maintenance, support and software upgrade

agreements with these suppliers and depends on them with respect to support of the network equipment that they produce. For other agreements with these suppliers see section 3.9.1 above.

3.13 Working capital

3.13.1 Stock holding policy

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

The period in which inventory is held is a consequence of Pelephone’s service policy and of its sales requirements. The requirements necessitate maintaining an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2006, the inventory level stands at an amount of approximately NIS 171 million.

3.13.2 Returns policy for terminal equipment purchased

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

Pelephone's policy, as at the date of this report, enables its customers to return equipment purchased within a period of 24 hours of the time of the transaction, in accordance with the agreement with customers and in with the conditions thereof, provided that no use has been made of either the product or the accessories to it.

With respect to remote sales transactions and peddling transactions as defined in the Consumer Protection Law, 5741-1981, return of equipment is permitted up to fourteen days after the date of the transaction, in accordance with the provisions of the Law.

3.13.3 Product warranty policy

Pelephone provides service, warranty and maintenance for terminal equipment in accordance with the level of service and repairs to which the customer has subscribed and of course in accordance with the provisions of any law which regulate issues of warranties for cellular terminal equipment.

3.13.4 Policy governing credit to customers

Credit in handset sale transactions – Pelephone enables most of its customers purchasing a mobile telephone to spread payments over 36 equal installments. Most of the payments for transactions are effected via credit cards. Pelephone deducts part of the transactions that are paid via credit card from payments to clearing companies.

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

As at 2006, total average customer credit less doubtful debts amounts to NIS 1,253 million.

3.13.5 Credit from suppliers

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2006, total average credit from suppliers and other trade payables amounts to NIS 621 million.

3.14 Investment in Investee Companies and in a Partnership

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

3.15 Financing

3.15.1 Pelephone's operations are financed by shareholders' equity, bank loans, debentures, credit card clearance and supplier credit.

The average interest rate in 2006 for undesignated loans was:

	Long-term loans (including current maturities)
Banking sources	
CPI-linked – NIS	4.78
Fixed Shekel	7.23
Dollar	4.87
Non-banking sources:	
CPI-linked – NIS	4.64

3.15.2 **Restrictions**

3.15.2.1 Undertakings towards banks

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

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

B As long as total debts exceed shareholders' equity by more than 2.5, Pelephone shall not pay out dividends and shall not pay management fees to shareholders. If Pelephone is in breach of this undertaking, it shall, within 120 days of demand, be required to repay the bank all loans outstanding to the credit of the bank at such time, or, alternatively, to amend the breach by increasing its shareholders' equity or repaying Pelephone's loan in such a way that the aforesaid ratio is preserved;

C. Total debts shall not exceed NIS 3.8 billion (linked to the CPI known as at January 2002). The sum of the debts shall be checked once every quarter in accordance with the financial statements that have been reviewed by accountants;

D. Not to mortgage Pelephone's assets under a fixed or floating charge, in any manner or way, or of any kind or degree, without obtaining the bank's prior written consent to such;

E. Not to provide Pelephone's shareholders or any third party whatsoever with any security or charge over the assets of Pelephone or any guarantee to secure credit received by the shareholders, without obtaining the prior written consent of the banks to such;

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

G. To provide the banks with various information, details and reports;

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

I. Undertaking to a particular bank – in addition to the above undertakings, Pelephone has undertaken to ensure that the cumulative sum of all of its debts and liabilities towards a particular bank shall be no greater than the equivalent of 40% of the cumulative sum of all of Pelephone's debts to financial entities including debentureholders.

3.15.2.2 Immediate repayment of the loan

A lender may call a loan for immediate repayment in certain instances (usually after serving written warning notice on Pelephone), foremost among such instances being:

(A) if any debt to the lender was not paid; (B) if Pelephone adopts a liquidation resolution or if application for liquidation or for the appointment of a liquidator is filed against it or if there is cause for its being liquidated, or for the appointment of a receiver or a trustee; (C) if application is filed for the imposition of an attachment or if an attachment is imposed on the assets of Pelephone or if any execution proceeding is taken against its assets or if it ceases to repay its debts; (D) if Pelephone adopts a resolution in favour of restructuring, merger or settlement or if the control therein is transferred without the lender's consent; (E) if Pelephone ceases to repay its debts or reaches a compromise with its creditors or any of them; (F) if Pelephone is in breach of any undertaking that it has assumed toward the lender or if it should transpire that a material declaration by Pelephone toward the lender is untrue; or (G) if an event should 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 Issue of Debentures

In 2004-2005, Pelephone issued three series of index-linked debentures by way of private placements to institutional investors in a total sum of NIS 1,133 million par value, in consideration for their par value.

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

As at December 31, 2006, Pelephone is meeting its commitments to the banks and to the debenture holders.

In 2006, no new long-term loans were taken.

For additional details regarding the composition of the loans and debentures, the conditions thereof and the date of repayment thereof during the report period, see Note 13 to the financial statements of the Company for the year ending December 31, 2006, which are included in this periodic report.

3.15.4 Credit limits

Pelephone's credit limits at banks in Israel amount to approximately NIS 2.09 billion as at 31, 2006. There are no signed agreements with the banks regarding this sum, but rather, there are oral agreements and non-binding written consents. As at December 31, 2006, Pelephone had utilized NIS 736 million of its credit limit at banks.

3.15.5 Guarantees and charges

See Notes 13 and 19 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

3.15.6 Credit rating

The rating company Maalot assigned Pelephone an AA minus rating on the placements of the debentures (see section 3.15.3 above). In December 2006, Maalot published a follow-up rating under which Pelephone was rated AA minus yet again.

3.15.7 <u>Pelephone's estimate of fundraising in the coming year and sources of financing</u>

Pelephone expects to repay a large portion of its loans during 2007, and it plans additional investments in property, plant and equipment. If necessary, Pelephone will raise new loans from banking corporations and/or by raising capital on the capital market.

The above information includes forward-looking information that is based on Pelephone's assessments taking into account its plans and the expectation that such will be realized. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.16 Taxation

See Note 8 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

3.17 Environmental matters

3.17.1 <u>Provisions regarding environmental protection</u> – see section 3.18.1.3 below.

3.17.2 <u>Anticipated costs and investments</u>

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

3.18 Restrictions on and Control of Pelephone's actions

3.18.1 <u>Statutory restrictions</u>

3.18.1.1 <u>Communications Law and licensing obligation thereunder</u>

The Communications (Telecommunications and Broadcasts) Law 5742-1982 stipulates, inter alia, that that performance of telecommunication activity and the provision of telecommunication services, including the MRT services, are subject to a license from the Minister of Communications (in this chapter – the Minister). Pelephone holds a general license for the provision of MRT services. The Minister is empowered to modify the terms of the license, to add thereto or to detract therefrom, while taking into consideration, inter alia, government telecommunications policy, considerations of public interest, suitability of the license holder to provide the services, the contribution of the license to competition in the telecommunications field and to the level of service therein. Moreover, the Minister empowered to annul, restrict or suspend a license in a number of situations (see Section 3.18.3.1 below).

The Law authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms. In this regard see also Section 2.16.13 above.

3.18.1.2 <u>The Wireless Telegraph Ordinance</u>

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

For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel (inter alia, due to the allocation of a great many frequencies for security uses), by limiting the number of licenses issued for

the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of a low range frequency on the other.

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

3.18.1.3 <u>Facilities emitting electromagnetic radiation</u>

Use of facilities that emit electromagnetic radiation is regulated in law as follows:

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

On December 20, 2005, the Non-Ionized Radiation Law 5766-2005 was passed, the commencement of which, for the purpose of regulation of radiation licensing, was set down for January 1, 2007. The provisions of the Law required a re-examination of Pelephone's preparations regarding compliance with the conditions of the Law.

One of the provisions of the statute provides that grant by the Radiation Commissioner at the Ministry of the Environment of a permit to operate cellular sites shall be conditional upon obtaining a building permit. Pelephone is acting to comply with statutory provisions as aforesaid and as at the date of this report, approximately 83%[22] of the sites in which Pelephone operates are authorized for the purposes of building permits. For the rest of its sites, Pelephone does have valid operating permits under the transitional provisions of the Law, and is working to obtain permits or alternative solutions in respect thereof.

3.18.1.4 <u>The Consumer Protection Law</u>

During the course of its operations, Pelephone is subject to the Consumer Protection Law, 5741-1981 (hereinafter: the "**Consumer Protection Law**"). In December 2005, the Consumer Protection Law was amended so that the prohibition against misleading conduct contained in the Law immediately prior to entry of the amendment into force, and the option of suing on grounds of misleading conduct by a dealer prior to the date of the contract, was extended to include misleading conduct by a dealer after the date of the contract.

3.18.2 <u>Controlled tariffs</u>

Payments for interconnections:

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

A For the purpose of interconnectivity payments received from a domestic operator or from another MRT operator for completion of one traffic minute on an MRT network, the current tariff for call completion is to be scaled down gradually to NIS 0.22 in accordance with the following outline (tariffs do not include VAT):

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[22] This figure includes approximately 13% of sites defined as access installations. These installations are exempt from building permits, although there are certain local councils which claim that such a permit is required and the matter is currently in the process of being examined in legal proceedings that were instituted by some of the authorities, and there are a number of private initiatives by Members of Knesset to amend the exemption granted in the law.

1. As of March 1, 2005, the current tariff of NIS 0.45 per traffic minute was reduced to a maximum tariff of NIS 0.32.
2. As of March 1, 2006, the tariff was reduced to a maximum tariff of NIS 0.29.
3. As of March 1, 2007, the tariff will be reduced to a maximum tariff of NIS 0.26.
4. As of March 1, 2008, the tariff will be reduced to a maximum tariff of NIS 0.22.

B With respect to payments received from an international licensee for completion of traffic on an MRT network, the current tariff of NIS 0.25 for call completion will be reduced, as of March 1, 2008, to a maximum tariff of NIS 0.22.

C. With respect to payments received from another MRT carrier for transfer of short messages (SMS) over an MRT network, the tariff was reduced in a two-stage format so that as of March 1, 2005, the maximum tariff for all SMS messages was set at NIS 0.05 and as of March 1, 2006, this tariff was reduced to a maximum tariff of NIS 0.025.

D. The tariffs in paragraphs (A) to (C) above will be revised once a year, commencing March 1, 2006, in accordance with the rate of change of the Consumer Price Index.

E. For the purpose of calculating payment for airtime and call completion to an MRT network, as of January 1, 2009, the charge will be made in accordance with segments of one second (unlike the current charging system which enables charging per segments of up to 12 seconds). Consequently, as of January 1, 2009, the payments payable by the MRT operator for interconnect services to a domestic operator's network will also be revised.

The following table itemizes tariff development:

Date	Domestic interconnect (per minute tariff)	International interconnect (per minute tariff)	SMS
To Sep 2000	62.0	62.0	
From Oct 2000	54.0	25.0	
From Jan 2002	50.0		
From May 2002	50.0		38.0
From Jan 2003	45.0		
From May 2004	45.0		28.5
From Mar 2005	32.0		5.0
From Mar 2006	29.69	25.6	2.56
From Mar 2007	26.59		
From Mar 2008	22.45	22.5	

Note: The tariffs are presented in Agorot and are exclusive of VAT. The tariffs as of March 2008 are adjusted for the CPI known in January 2007.

3.18.3 License and site licensing

3.18.3.1 Pelephone's license

The General License for the provision of MRT services granted to Pelephone on February 7, 1996 was for a period of 10 years commencing January 1, 1994, with an option of extending it for additional periods of 6 years each, under the conditions set forth in the license, consisting primarily of compliance with statutory conditions. Following the tender in which Pelephone was allotted third generation frequencies, the license was extended to be valid for 20 years as of September 9, 2002. For the arrangement with the State regarding the right to use frequencies, see Note 18 to the financial statements of the Company for the year ended December 31, 2006, included in this periodic report.

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

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

A Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, and in certain instances to 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 ion the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.

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

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

E. The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest[23] over another licensee, whether for the payment for the service, whether in the conditions of the service, whether in its availability or otherwise.

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

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

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

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

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

I. The license sets forth the types of payments that the licensee is entitled to collect from its subscribers for cellular services, the mechanisms of setting

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

tariffs, the reports the licensee is obliged to submit to the Ministry of Communications and also the duty of serving notice on the Ministry of Communications prior to modifying tariffs. The license also determines the Minister's power to intervene in tariffs, in certain cases.

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

K To secure the licensee's undertakings and also in order to compensate and indemnify the State of Israel in the event that it sustains damage due to acts of the licensee, the licensee must furnish a bank guarantee in the amount of $ 10 million. The license determines the instances in which such guarantee maybe forfeited.

As aforesaid, the Minister is authorized to amend, add to or detract from the conditions of the license. The following are the principal amendments to Pelephone's license that are being examined by the Ministry of Communications or that were recently imposed:

A Recently, the Ministry of Communications amended the licenses of cellular carriers regarding restriction of access to the internet by users for the purpose of obtaining services including adult content. The amendment provides, *inter alia*, that access to erotic services contained in the cellular portal or via an application such as a search engine, included in the cellular portal and enabling access to sites on the internet shall be blocked by default to all subscribers, and only adults over 18 years old may request to have the obstruction removed from their cellular telephones, using the reliable identification procedure. The amendment to the licenses came into force on March 30, 2006. Partner and Cellcom petitioned the High Court of Justice against this amendment.

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

C. In August 2006, the Ministry of Communications wrote to the cellular companies asking for a response to its intention to amend the companies' license regarding removal of the connection between an MRT terminal handset purchase transaction and the giving of benefits. According to the proposed amendment to the license, the licensee is not to create any connection between a transaction for the purchase of terminal equipment from MRT companies and the provision of a financial benefit for consumption of air time, or other benefits. In light of this, the Ministry of Communications is considering cancelling the connection between the sale of terminal equipment by the carriers and giving benefits relating to MRT services. That is so as to enable cellular company subscribers who have purchased terminal equipment from another provider or from equipment suppliers who are not cellular providers, to receive the same conditions, including monetary credit for consumption of air time, to which they would have been entitled had they purchased the terminal equipment from the cellular company in which they are subscribers. Pelephone expressed its objection to the aforesaid license amendment and submitted an economic opinion together with its objection. At this stage, Pelephone cannot assess the effect of the amendment of the license as aforesaid if it is passed.

D. In September 2006, the Ministerial Socio-Economic Committee approved the proposal by the Ministry of Communications to amend the Communications

(Telecommunications and Broadcasts) Law, 5742-1982 (the "**Communications Law**") so as to enable an increase of the fines that the Ministry may impose on communications companies for breaches of the provisions of the Communications Law. According to the proposal, which was approved, a licensee whose revenues during the financial year preceding the date of the breach were more than NIS 100 million shall be fined the sum of approximately NIS 1.4 million (seven times the fine set out in section 61(a)(4) of the Penal Law) plus 0.25% of the total revenues of the licensee during the financial year preceding the date of the breach. This amendment was approved by the Knesset in January 2007, as part of approval of the Arrangements Law.

In September 2006, the Ministry of Communications submitted a proposal for a broad-based amendment of the Communications (Amendment No. 34) Law.

Under the proposed amendment, the government will be given special powers during communications crises in times of national emergency. During the discussions before the Economic Committee of the Knesset, and as part of the drafting of the bill for Second Reading, a request was made to extend the application of "communications crises" to include scenarios that are not a national emergency, such as communications failure by a particular communications carrier, which harms the whole population or part thereof. Therefore, the Ministry decided to extend the amendment by adding a new section 13B. Pelephone has expressed its objection to this amendment by addition of the new section 13B, but the Ministry of Communications did not accept its position.

The bill was approved upon Third Reading in the Knesset in November 2006.

The above information includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.18.3.2 Royalties

Pursuant to the Telecommunications (Royalties) Regulations, 5761-2001 and its license, Pelephone pays royalties to the State of Israel out of its revenues which attract royalties from the provision of telecommunications services, *inter alia* less revenues and expenses in accordance with the guidelines in the Royalties Regulations. In 2006, the rate of these royalties amounted to 3% of its royalty-attracting revenues. Under the Regulations, the rate of royalties is to reduce by 0.5% to a rate of 1% from 2010 and onwards, so that in 2007, Pelephone will pay royalties in a rate of 2.5%, in 2008 - 2%, in 2009 - 1.5% and from 2010 onwards - 1%. In this regard, see also reference to a lawsuit filed by the State of Israel against Pelephone with respect to non-payment of royalties in Note 17(a)(20) to the Company's financial statements for the year ended 2006, included in this periodic report.

3.18.3.3 Site licensing

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

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

A Approval for erection and operation from the Ministry of the Environment (See Section 3.17.1 above)

B Approval of the Civil Aviation Administration in some cases.

C. Approval of the IDF.

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

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

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

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the IDF, even though the applications for the approvals have long since been in the hands of those authorities. Similarly, administrative or other delays occur in some planning and building authorities in the issue of building permits for sites. Therefore, Pelephone (and its competitors) operate a number of broadcast sites without having any building permits, and this is regulated under the Non-Ionized Radiation Law (see section 3.18.1.3 above). Applications for the building permits have been filed by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

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

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

Pelephone, like Israel's other MRT operators, is liable to be required to dismantle broadcasting sites for which the necessary approvals and permits have not been obtained in accordance with the dates prescribed at law. If it is legally required that sites in a given geographic area be simultaneously demolished, service in that area is liable to deteriorate, until substitute broadcasting sites can be built.

Likewise, Pelephone, like Israel's other MRT operators, provides internal relays inside buildings in order to provide service in the buildings. These relays are small facilities that are attached to external antennas of around 60 cm in length. This antenna enables a broadcast signal to be received from a close broadcast site, which is then relayed into the building. Radiation emissions from these kinds of small antennas are similar to emissions from cellular terminal equipment. These relays have received a class approval from the Ministry of Communications.

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

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

permits are also required for the installation of facilities of this type, such decision could negatively impact the installation of such facilities.

What is more, on December 20, 2005, the Non-Ionized Radiation Law, 5766-2005 was passed by the Knesset, the commencement of which, with respect to the regulation of radiation licensing, has been set down for January 1, 2007. Implementation of the provisions of the Law and the procedures that are to be prescribed under it required Pelephone to make appropriate arrangements which were in fact make. In addition, the very fact that the operations permits under the Law are subject to receipt of a building permit constitutes yet another obstacle on the way of delaying adjustment of the network as aforesaid.

3.18.3.4 Establishment of communications installations - National Outline Plan 36

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

NOP 36A is supposed to simplify and streamline the setting-up processes of miniature and small broadcasting facilities. It stipulates clear obligations and guidelines and creates a uniform framework for processing permit applications. Approval of NOP 36A did not give rise to the regulation desired and many planning authorities have complained about the provisions of the plan, and in particular, about the following two matters:

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

This state of affairs caused no end of discussions between the cellular companies and the planning committees, which brought with it a multitude of claims in this area. Likewise, the planning committees have campaigned strongly to amend NOP 36A.

As a result of that, at the beginning of 2005, the National Planning and Building Council adopted the following resolution:

1. No building permit shall be issued unless the applicant for a permit deposits a deed of indemnity with the local authority in respect of compensation pursuant to Section 197 of the Planning and Building Law, to cover such compensation as the committee may be ordered to pay. Section 197 of the Planning and Building Law confers on landowners injured by a plan applied on their land or on neighboring land the right to compensation from the local committee. The described amendment of NOP 36A is liable to subject Pelephone to not inconsiderable financial obligations 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 these obligations nor the extent thereof, in Pelephone's assessment they are not very likely, and they will not, of course, result automatically from the decision of the national council to amend NOP 36A.
2. Further to the directives of the National Council as at August 3, 2004, the drafting committee will formulate an amendment to the NOP with respect to extension of the local committees' discretion, and notification of the public.
3. When the draft resolution concerning extension of the discretion of local committees is submitted to the Council, the possibility of changes in the indemnification obligation and the extent thereof will be examined.

All the aforementioned resolutions are subject to Government approval.

On July 24, 2005, the government of Israel resolved to defer approval of the resolution of the National Council for Planning and Building to amend National

Outline Plan 36A dealing with the setting up of small and miniature broadcast facilities for the time being. The amendment revolved around extending the discretion of the local committees, granting a right of objection to the public and requiring the companies to make undertakings to indemnify the planning committees for claims for devaluation of land. The MRT companies' share of the indemnification was set at 80% of the devaluation, the balance to be borne by the local councils. This postponement was intended to allow the CEO committee that was set up, to submit its conclusions within three months. The Committee submitted its conclusions to the government, which set out its recommendations, the main ones being:

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

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

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

This state of affairs will have severe implications on the ability of the cellular companies (including Pelephone) to develop their networks, and the existence of an indemnification obligation might impose an inestimably heavy economic burden on them. Pelephone's assessment as aforesaid is forward-looking information which might not come to fruition.

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

As at the date of this update, Pelephone has deposited 85 deeds of indemnity under the Law with various local councils.

3.18.4 Antitrust

The document setting out the conditions of the merger between Pelephone and Bezeq sets out various restrictions as to cooperation between the companies. During the course of 2006, Pelephone applied to the Antitrust Commissioner to cancel the conditions of the merger with Bezeq or to provide relief for such conditions so as to enable cooperation between it and Bezeq. Pelephone has not yet received a response from the Antitrust Authority.

3.18.5 Standards

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

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

The certificate was awarded on January 11, 2004, and is valid until October 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 Substantial agreements

For undertakings to banks, see section 3.15.2 above.

For trust deeds signed with the Union Bank Trust Company Ltd. at the time of issue of debentures, see section 3.15.3 above.

3.20 Joint venture agreements

For joint venture agreements with content suppliers regarding added value services, see section 3.12.2 above.

For roaming agreements see section 3.2.1 above.

3.21 Legal proceedings

For legal proceedings, see Notes 15 and 17 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

3.22 Goals and Business Strategy

Pelephone's principal strategic goals are:

1. Improve profitability;
2. Lead with third generation technology;
3. Grounding Pelephone's brand as valuable in the field of mobile entertainment and in the private and business sector.
4. Increasing its market share in the long term.

Pelephone operates in accordance with the following brand values: Simplicity, fairness, flexibility and innovative empowerment.

In order to achieve its goals, Pelephone is operating on a number of levels:

1. Increasing customer satisfaction

   Pelephone acts to increase its customers' satisfaction and to strengthen their loyalty to Pelephone's services. These operations are expressed in an improvement of the service system, terminal equipment upgrading offers, and the grant of benefits to Pelephone's customers under a marketing shell which reinforces the Pelephone-customer relationship.

2. Leading the third generation

   Pelephone has set itself a goal of being third generation leader in the Israeli market. This leadership will be expressed by an increase in revenue from third generation services and by the number of subscribers who join such services.

   Leadership will be attained by:

   A Launching a broad range of third generation handsets.

   B Setting up a communications structure to cover all content.

C. Placement of Pelephone as a company that supplies the best 3G cellular entertainment.

3. Continued investment in infrastructure

Pelephone is considering setting up another cellular network using UMTS technology (see section 3.1.5.3 above).

The above information includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.23 Development outlook for the coming year

During 2007, a number of factors are expected to affect Pelephone’s activities, the principal ones are as follows:

3.23.1 Continued reduction of interconnectivity fees

As set out in section 3.18.2 above, on March 1, 2007, interconnect fees will drop by another 3 Agorot. This reduction might harm Pelephone’s revenues.

3.23.2 Third generation services

Pelephone expects that during 2007, it will increase the amount of customers that use third generation services, it will increase its supply of such services and as a result, Pelephone will continue to increase its revenues in this field.

3.23.3 Innovative added value services

In 2007, Pelephone is expected to continue to launch a diverse range of advanced added value services that will help improve the perception of the brand and increase revenues from existing customers such as:

- IM – the ability to send instant messages similar to ICQ or MSN Messenger.
- ICOM – development of photographs using MMS.
- Personal clips – a platform for preparing personal clips for sending by MMS or email.
- Search for me – an IVR service for finding the precise location of children.

3.23.4 Number Portability

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

3.23.5 Set-up of another cellular network

During the course of 2007, Pelephone’s competent organs are expected to pass a resolution regarding the setting up of an additional cellular network using UMTS technology (see section 3.1.5.3 above).

The information in this section includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.25 below.

3.24 Event or matter deviating from the ordinary course of the corporation’s business

For presentation anew of the financial statements in accordance with Israeli accountancy rules (balance sheet as of date of transition, profit and loss for 2005 and balance sheet for December 31, 2005), see Note 33 to the financial statements of the Company for the period ended December 31, 2006, included in this periodic report.

3.25 Discussion of Risk Factors

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

3.25.1 <u>Macro-economic risk factors:</u>

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

3.25.1.2 Exposure to fluctuations in exchange rates, interest rates and inflation – Pelephone is exposed to risks caused by fluctuations in exchange rates, since most purchases of terminal equipment, accessories and spare parts are in US dollars, whilst Pelephone's income is in Shekels. Erosion of the shekel as against the Dollar might harm Pelephone's profits in the event that adjustment of sale prices is not permitted in the short term. Accordingly, Pelephone is investing a considerable share of its cash balances in deposits that are exposed to changes in real yields as a result of inflation rate fluctuations. Those of Pelephone's loans and debentures that are linked to the consumer price index bear fixed interest and therefore fluctuations in the interest rate will affect the fair value of them, but not their on-book value.

3.25.2 <u>Industry-based risk factors:</u>

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

3.25.2.2 Customer credit – Pelephone's sales to its customers are mostly done on credit. Some of this credit is secured using credit insurance which includes policyholder's contributions, and some is secured by sureties provided by customers. The other part of this credit, which is not covered by either insurance or sureties, is exposed to risk. Due to the large spread of its customers, Pelephone assesses that the extent of its risk of substantial harm to its business results is low.

3.25.2.3 Regulatory developments – in the area of Pelephone's operations, there is a trend to legislate and impose standards on issues such as the environment, increased competition, product liability and the methods used for repairing products, etc. These regulations might increase the costs of services and marketing, and due to the stronger competition it might not be possible to roll those costs in full onto consumers, as a result of which, profits in the industry might be eroded.

3.25.2.4 Competition – the cellular market in Israel is characterized by a high degree of saturation, strong competition and is exposed to influences and competition as a result of technological developments.

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

3.25.2.6 Site licensing – the erection and operation of cellular antennas are subject to building permits from the various planning and building committees, a process that involves, inter alia, obtaining a number of approvals from Government entities and regulatory bodies. For details of the difficulties encountered by Pelephone in the erection and licensing of sites, see Section 3.18.3.3 above.

3.25.3 **Pelephone's Risk Factors**:

3.25.3.1 Terminal equipment quality – Pelephone might be exposed to losses in the event of malfunctions in the terminal equipment that it sells, including indirect damages that might be caused as a result of such malfunctions.

3.25.3.2 Property risks and liabilities – Pelephone is exposed to various property risks and liabilities. Pelephone employs the services of an expert external insurance consultant in this field. Pelephone has insurance policies which cover the usual risks to which Pelephone is exposed within the limits of the conditions of such policies, such as: Various forms of property insurance, various forms of liability insurance, loss of profits, third party liability insurance and office-bearers' insurance.

3.25.3.3 Serious malfunctions in information systems – Pelephone's information systems are networked throughout the country via designated communications lines and via the internet. Pelephone's business is highly dependent upon these systems. Large-scale malicious harm or malfunction might adversely affect Pelephone's business and results.

3.25.3.4 Serious malfunctions in the communications network – Pelephone's communications network is spread out around the country via network core sites and antenna sites. Pelephone's business is totally dependent upon these systems. Large-scale malicious harm or malfunction might adversely affect Pelephone's business and results.

3.25.3.5 Legal proceedings – Pelephone is party to legal proceedings, including class actions, which are liable to result in its being ordered to pay material amounts that cannot presently be estimated, and in respect of most of which no provision has been made in Pelephone's financial statements. Pelephone is exposed to class actions. Class actions may reach high amounts, since approximately one third of the residents of the State of Israel are Pelephone consumers, and a claim relating to a small amount of damage to a single consumer may grow into a material claim against Pelephone if recognized as a class action applicable to all or a large proportion of those consumers for legal proceedings to which Pelephone is a party.

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

The following are the risk factors as described above, and their effect in the opinion of management, on the results of its business:

Effect of Risk Factor on all of Pelephone's Activity

Risk factors	Large	Medium	Small
Macro-economic risk factors:			
Recession		X	
Exposure to exchange rate and CPI fluctuations		X	
Industry-based risk factors:			
Investments in infrastructure and technological changes	X		
Customer credit			X
Regulatory developments	X		
Competition	X		
Electromagnetic radiation*			
Site licensing	X		
Pelephone's Risk Factors:			
Quality of terminal equipment		X	
Property risks and liabilities			X
Serious malfunctions in information systems	X		
Serious malfunctions in the communications network	X		
Legal proceedings		X	
Restrictions applicable to frequencies and disturbance in use of frequency range		X	

* Pelephone is unable to assess the degree of effect of this risk factor on its activity.

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

4.1 General

4.1.1 Structure and changes in area of operations

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

In addition to the international call services (hereinafter: "Voice Services"), Bezeq International provides data communications services (hereinafter: "Data Services") internet access services (ISP) (hereinafter: "Internet Services"), value-added services, telephony traffic routing services between foreign international communications suppliers and server and site hosting services (hereinafter: "Hosting Services"), and integration services under which Bezeq International's business customers are offered total communications solutions (which include Data Services, Hosting Services and technical maintenance and support services for networks) (hereinafter: "Integration Services").

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

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

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

4.1.2.1 General license

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

4.1.2.2 Application for a special domestic license

On May 16, 2006, Bezeq International submitted an application to the Ministry of Communications for a special general license for the provisions of domestic fixed-line telecommunications services. The grant of such a license under which, *inter alia*, domestic VOB services would be provided (which constitute the necessary portion of the mixture of products provided by internet service providers) will enable Bezeq International to continue providing its customers with inclusive communications solutions (of the kind that its competitors offer, some of which competitors have already received similar licenses) and to compete as an equal to them.

As at the date of this report, the Ministry of Communications has not yet made a decision regarding the above license application.

4.1.2.3 Special license to conduct marketing trial for provision of VOB services

On December 6, 2004, the Ministry of Communications granted Bezeq International a special license to conduct a marketing trial for the supply of domestic telephony services using voice over broadband (VOB) technology. Under the trial, Bezeq International was permitted to provide full VOB services for a fee, to a maximum number of 8,500 lines. The trial license was granted to Bezeq International for one year at first, and was extended from time to time, the last extension being until February 28, 2007. Following an application for an interim injunction in a petition filed by Bezeq International against the Minister of Communications and others, set out in section 4.19.4 below, the Ministry of

Communications gave notice to Bezeq International, on February 27, 2007, of extension of the force of the marketing test pending a ruling on the above petition.

4.1.2.4 Royalties

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

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

With respect to the royalty rate – in August 2006, the Ministries of Communications and Finance approved the Telecommunications (Royalties) (Amendment) Regulations 5766-2006 under which the rate of royalties was reduced from 3.5% to 3% as of January 2006. Likewise, the amendment provided that the rate of royalties would fall gradually so that in 2007, it would be 2.5%, in 2008 – 2%, in 2009 - 1.5% and as of January 1, 2010, the rate would be 1%. In this regard see also Section 2.16.3 above.

4.1.3 Principal entry and exit barriers

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

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

4.1.3.3 The principal exit barriers from these markets stem from long-term binding agreements with suppliers and investments requiring long repayment periods. In addition, Bezeq International is obligated to provide service to its customers throughout the period of its agreement with them.

4.1.4 Alternatives to Bezeq International products

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

4.1.5 Structure of competition in the sector and changes therein

In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. In July 1997 two other international operators entered this arena: Barak I.T.C. (1995) - International Telecommunications Services Company Ltd. and 012 Golden Lines Ltd., and this led to a sharp fall in the prices of international calls and extensive growth in market volume. In April 2004 the Communications (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services) Regulations, 5764-2004 entered into effect. As at the date of publication of this report, the Ministry of Communications has granted general licenses for the provision of international telecommunications services to three more operators: Internet Gold-Kavei Zahav Ltd. (Internet Zahav), Netvision Ltd. and Xfone Communication Ltd., all of which

started operations by the end of 2004. The expansion of competition has led to an additional fall in the prices of international calls, although, unlike 1997 when competition began, the volume of international traffic did not undergo a significant increase, since prior to the expansion of competition, call prices did not constitute a factor preventing the public from using the service. The above-mentioned expansion of competition had a negative effect on the results of Bezeq International's operation and on its financial condition, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector.

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

In December 2004, the Ministry of Communications permitted Bezeq International to provide fixed line telephony services over its internet network (VOIP) to 8500 customers for a trial period of one year (which was extended to the end of August 2006).

On April 20, 2005 the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the licensing of the provision of telephony services by means of broadband access (VOB – Voice Over Broadband), in a way that will prevent Bezeq International (a subsidiary of the Company) from providing the service until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and in November 2007. This policy amendment, if adopted, is liable to oust Bezeq International from this developing market, thereby awarding its competitors in internet access and international dialing services (most of which have received marketing trial licenses from the Ministry of Communications for providing these services and some are already operating in accordance with it) a clear competitive advantage in that they will be able to offer their customers a total communications solution combining access to the Internet, international telephony and fixed-line domestic telephony services. On February 2, 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims regarding the entry of the aforementioned policy amendment. Following the hearing, on February 8, 2006, the Ministry of Communications published a notice of its intention to ease the limitation on Bezeq International and to permit it to act in the field of VOB, under certain restrictive conditions.

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

The inability of Bezeq International to offer a similar total solution in the event that, at the end of the day, it will not be allowed to provide VOB services, or substantial limitations are imposed upon it in this regard, might cause the departure of existing customers in favor of the services of competitors, and might give rise to difficulties in getting new customers. Bezeq International is unable, at this stage, to estimate the effects of churn as aforesaid on the results of its operations and its financial condition. In this regard see also Section 2.6.1 above.

Implementation of the numbering and number portability plan (see Section 2.6.6 above) might require Bezeq International to make additional investments in infrastructure and equipment. Bezeq International cannot, at this stage, estimate the total extent of such investments.

4.2 Products and Services

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

4.2.1 Voice Services

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

4.2.2 Internet Services

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

4.2.3 Data Services

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

4.2.4 Integration Services

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

4.3 Revenues

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

	2006	2005	2004
Total Revenues	1,022	815	810
Percentage of gross profit	35%	35%	38%

4.4 New Products

Following are descriptions of the principal new products launched in 2006:

4.4.1 **"Supplier Portal" Service** (formerly a Bezeq Gold Service) – an electronic platform for following up orders and invoices between customers and suppliers.

4.4.2 **"Bank Flash" Service** (formerly a Bezeq Gold service) – which enables customers who work with a number of different banks to receive details of their account movements in a concentrated manner, directly to their accounts management.

4.4.3 **VMWARE** – which offers a virtual server that is stored and managed by Bezeq International (and not by the customer) in a format which enables a number of virtual server environments on one physical server.

4.4.4 **Managed Firewall services** – managed information security services stored and managed at Bezeq International rather than the customer – the customer has no need to manage the "box" on site.

4.4.5 **Service contract service** – which enables small and medium businesses to purchase hour banks or to pay per call for support and service in IT, networking and systems issues.

4.4.6 **Prepaid site** – a site for online sale of prepaid cards for calling overseas from Israel and for calling Israel from overseas, at attractive prices.

4.4.7 **Bigger inbox** for private customers – inbox increased to 1G.

4.4.8 **Safe net** – an antivirus service which protects against viruses and worms, etc.

4.5 Marketing, Distribution and Service

4.5.1 The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International –which are used by Bezeq International to remain in contact with the 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.

4.5.2 Bezeq International operates sales channels for the private market, as set out below:

4.5.2.1 Recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files.

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

4.5.2.3 National direct sales setup conducting “door to door” operations, operating points of sale and managing customers.

4.5.2.4 Distribution channel setup including external centers and field systems for resellers and dealers.

4.5.2.5 Yes@wow – a joint venture with DBS in which subscribers are recruited for integrated packages comprising internet access, multi-channel television, Company internet access infrastructure (for further details see also Section 5.16 below).

4.5.3 Bezeq International operates sales channels for the private market, as set out below:

4.5.3.1 New customer recruitment center – for SMB customers under the ingoing and outgoing call model, using files.

4.5.3.2 Increased existing customer volume center – for SMB customers under the ingoing and outgoing call model, using files.

4.5.3.3 Customer portfolio retention center which handles the “heaviest” customers in the SMB sector, retains them and increases revenues from them. This center also acts as a second line regarding retention matters.

4.5.3.4 National direct sales setup conducting “door to door” operations, operating distributors and recruiting SMB customers.

4.5.3.5 A telemeeting center for setting and coordinating meetings with potential customers for SMB and SME customers.

4.5.3.6 SME field which concentrates customer managers who recruit and manage medium-sized customers on an ongoing basis.

4.5.3.7 ENT field which concentrates customer managers who recruit and manage strategic customers on an ongoing basis.

4.6 Competition

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

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

The competition, which is characterized by a trend of erosion of tariffs, is expected to continue to fall towards the second half of 2007.

4.6.1 <u>Voice Services</u>

4.6.1.1 In 2006 there were six competitors operating in the market: 014 Bezeq International, 013 Barak, 012 Golden Lines, Internet Zahav, 017 Netvision and 018 Xfone.

Some of these companies are in the process of merging. When the mergers take effect, there will be four competitors left on the market: Bezeq International, the Barak-Netvision Group, the Internet Zahav Golden Lines Group, and Xfone. In 2007, each of the merged companies will still operate two dial codes. Unification of the codes 013+017 and 012+015 will take place in fact in 2008.

In Bezeq International's estimation, its market share in the area of these services is 32%.

4.6.1.2 General characteristics of competition in 2006:

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

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

4.6.1.2.3 The product is a commodity.

4.6.1.2.4 The market is a price market (perception).

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

4.6.1.3 The multitude of competitors and the penetration of VoIP technology increases competition. This increased competition is expressed in ever decreasing prices and profit erosion.

4.6.2 <u>Internet Services</u>

4.6.2.1 <u>This market has five significant competitors</u>: 014 Bezeq International (estimated market share 36%), Netvision (estimated market share 21%), Internet Zahav (estimated market share 16%), 012 Golden Lines (estimated market share 16%), and 013 Barak (estimated market share 11%).

4.6.2.2 When the aforesaid mergers take effect, there will be three significant competitors in the market: Bezeq International, the Barak-Netvision Group, and the Internet Zahav Golden Lines Group.

4.6.2.3 <u>General characteristics of competition in 2006</u>:

4.6.2.3.1 72% of Israeli households are connected to the internet (95% of them have high-speed connections).

4.6.2.3.2 ADSL is the leading infrastructure (64% of high-speed internet connections)

4.6.2.4 <u>Developments in 2006:</u>

4.6.2.4.1 Continued slow-down in rate of growth of high-speed internet compared with previous years. This requires that a focus be placed on retention of customers and recruitment of customers from competitors.

4.6.2.4.2 Continued transition of customers to higher speeds as a result of the launch of 2.5 M speeds in March 2006, and of encouragement of telecommunications and cable infrastructure providers and internet service providers.

4.6.2.4.3 The issue of price will continue to be critical in recruiting customers and the trend of transition from an emphasis on low prices to an emphasis on high speeds, service and bundles will continue, and the offers of an internet package with VoIP or packages containing content will expand.

4.6.2.4.4 Strengthening of the trend of selling bundle and triple packages in the market.

4.6.1. **<u>Solutions for the business sector – Bezeq International business</u>**

<u>Characteristics of the business arena in 2006</u>

Viewing the customer as the center and with the desire of increasing revenues from business customers, Bezeq International started supplying integration services to businesses in 2006, providing full solutions in areas such as system, networking, IT, hosting, voice, data, ISP, wireless, etc.

The solution is that of a full solution model for the customer, without relying on external suppliers, the customer getting a single contact person and which full responsibility for the process (one supplier. One responsibility).

With the commencement of provision of integration solutions, Bezeq International is dealing with new competitors in this field, such as Binat, Teldor, IBM, and others.

The rest of the companies that are in competition with Bezeq International, and which, together with the Bezeq Group, fall into two main communications groups, are also trying to reinforce this field and competition is expected from that direction as well: The expectation is that Internet Zahav will reinforce its integration solutions in the merged company, and that Netvision will also continue to do so.

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 are seasonal fluctuations in the following services:

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

4.7.2 Voice Services for the private sector – increase in the summer months and towards the end of the civil year.

4.7.3 Internet services – the best results are usually obtained in the fourth quarter, whilst in April-June, recruitment figures are usually lower.

4.7.4 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 Property Plant & Equipment

4.8.1 In the periodic report for 2005, Bezeq International referred to international communications infrastructure (underwater cables and international switches) which Bezeq International leases (mainly from Mediterranean Nautilus Limited) as plant and equipment. Upon adoption of IFRS, these Bezeq International rights in international infrastructure can no longer be regarded as plant and equipment. For reference to Bezeq International's contract with the infrastructure supplier Mediterranean Nautilus, see section 4.11.5 below.

4.8.2 Towards the end of 2004, Bezeq International signed an agreement with Veraz, to purchase SoftSwitch switches which, during the course of 2005, replaced the Alcatel S-12 voice switches (which, at this stage, are still being used as a non-substantial component in the Company's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on

an Intelligent Network (IN), which were also replaced in 2005 as part of the upgrade of its voice setup.

Bezeq International's technological infrastructures which support the voice, data and internet setups are deployed in four sites in order to provide services with high survival. During the course of 2005, Bezeq International set up another site in London, England, via which advanced services are provided to its customers.

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

4.8.3 4.8.3 On November 14, 2006, Bezeq International signed an agreement with Avnet Choshen Building and Investment Company Ltd. for lease of an area of approximately 7,000 sqm for a period of 8 years and four months, expected to commence in April 2007, and to terminate in July 2015, with an option to extend the lease term for two years each time, and up to an additional 8 years.

4.9 Intangible assets

4.9.1 License for the provision of Bezeq International services

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

4.9.2 Acquisition of operations of Goldnet Communications Services (Bezeq Gold)

On April 30, 2006, Bezeq International signed an agreement with Malam Systems Ltd. (hereinafter: Malam) and the Company to purchase all of the operations done by Goldnet Communications Services (hereinafter: Goldnet), a registered partnership held by Malam (25%) and the Company (75%), which provides solutions for secure distribution and transfer of information electronically between organizations, in consideration for the total sum of NIS 6.8 million which should be paid to Goldnet. As part of the acquisition, all of the agreements between Goldnet and its customers and suppliers, and franchise agreements and joint venture agreements to which it was a party were assigned to Bezeq International, and all of the intellectual property, inventory and/or property, plant and equipment of Goldnet were transferred to it as well.

Once all of the preconditions set out in the acquisition agreement had been fulfilled, Goldnet, which had run its business under the trade name "Bezeq Gold", ceased to provide services. However, for a period of 12 months following the date of competition of the acquisition transaction, Goldnet will continue its contracts with customers under those agreements which could not be assigned to Bezeq International, and will transfer all of its receipts from such to Bezeq International. On June 30, 2006, Goldnet fired most of its employees and paid them all of the moneys that they were entitled to for termination of their employment. The majority of them were taken into to various positions at Bezeq International, in accordance with the provisions of the agreement.

After execution of the agreement, a supplier of services to Goldnet exercised its right to refuse assignment of its contract with Goldnet to Bezeq International. Bezeq International reached an agreement with the supplier under which it sold the supplier the right to continue contracting with existing customers of Goldnet for the services that it provided, subject to payment of consideration by the supplier, which does not harm the feasibility of the transaction.

4.9.3 Acquisition of Actcom Active Communications Ltd.

On December 13, 2006, Bezeq International executed a transaction to acquire 100% of the shares of Actcom Active Communications Ltd., the oldest supplier of internet access services in Israel, from its two founders. Actcom, whose offices are in Haifa, shall continue to run its business as an independent subsidiary of Bezeq International.

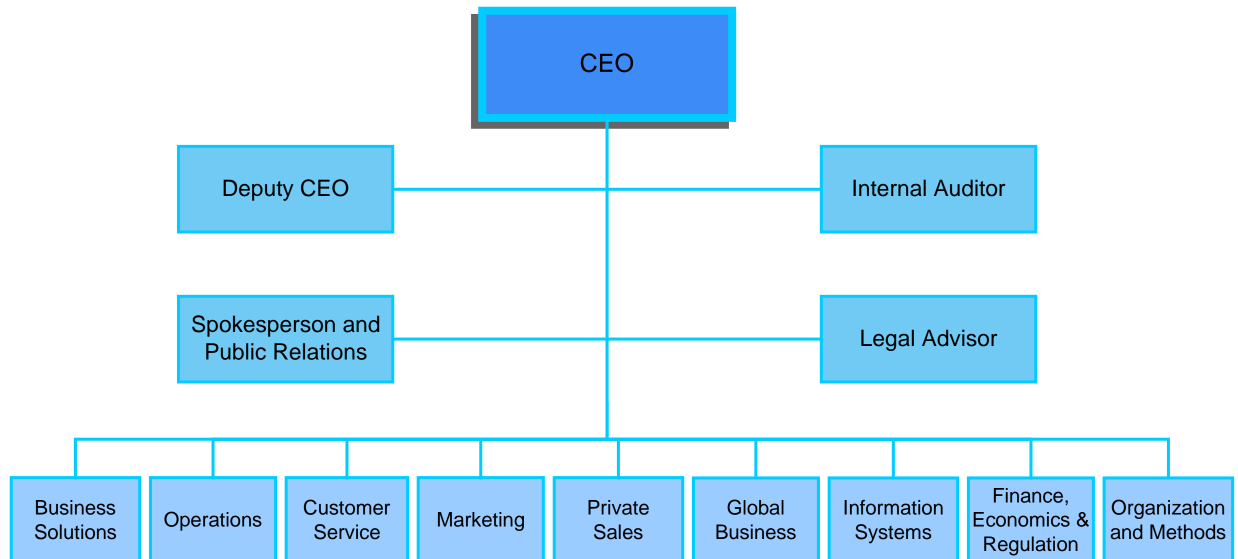
For the merger of Bezeq International's operations with BezeqCall Communications Ltd. (a wholly owned subsidiary of Bezeq which deals in the field of network end points) see update to section 1.1.5 above.

4.10 Human Resources

4.10.1 The number of persons employed by Bezeq International (employees of the Company, employees of human resources firms or outsourced) is 1,951, of whom: 510 are HQ staff (management, finances and human resources, marketing, information technology, operations, global business and business solutions), and 1,019 are service and sales staff.

4.10.2 <u>**Organizational structure**</u>

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



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

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

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

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

4.11 Accounts Payable

4.11.1 In February 2005 Bezeq International signed an agreement with SigValue for the purchase of an intelligent network system, the cost of which is not material. Bezeq International will be dependent on this provider.

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

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

4.11.4 Bezeq International has financial relations with some 100 foreign operators, in approximately 240 destinations worldwide. The substantial foreign carriers in terms of size

and cost of traffic passing through them are: British Telecom, Rostelecom, Paltel, AT&T, etc.

4.11.5 Bezeq International is dependent upon the international communications infrastructure provider Mediterranean Nautilus Limited, which supplies it with most of the international communications infrastructure that it requires via a submarine cable operated by it from Israel to Europe. From there onwards, Bezeq International makes use of other infrastructure for the purpose of connecting to the rest of the world.

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 4.12.2 Bezeq International has surplus current liabilities over current foreign currency assets stemming from Bezeq International's contracts with foreign international communications carriers for the transmission of voice minutes and the purchase of data services (see Section 4.21A) which were significantly reduced in 2006 as a result of Bezeq International's operations to close old accounts with them, and this considerably improved the deficit in net balances. As at the end of 2005 and 2006, Bezeq International has positive working capital.

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 policies

4.13.1 **Credit to customers**

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

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

4.13.2 **Credit from suppliers**

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

4.14 Investments

As at December 31, 2006, Bezeq International held 44.04% (33.66% under full dilution as at 2006) 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. During the course of 2006, Bezeq International and others exercised option warrants of Walla! (series 3). In all, Bezeq International exercised 2,564,764 option warrants (series 3) in 2006, in consideration for a total sum of NIS 4,617,000, which was set off against the balance of the shareholders' loans provided by Bezeq International to Walla! Following exercise of the option warrants, the Company has a cost surplus in the sum of NIS 2,313,000, which was ascribed to fair value of intangible assets based on purchase price allocation (PPA) work done by an external appraiser.

After the balance sheet date, and prior to the date of publication of this periodic report, as a result of exercise of additional option warrants (series 3) by other persons, the rate of Bezeq International's holdings of Walla! fell to 42.57% (33.66% fully diluted). The balance of Bezeq International's investment as at 2006 amounted to NIS 32.1 million, while its market value amounted to approximately NIS 125.8 million.

Walla! concluded 2005 with a net profit of approximately NIS 12.3 million and 2006 with a net profit of approximately NIS 25.5 million.

For additional details regarding Bezeq International's investment in Walla, see Note 12 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

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

4.15 Financing

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

4.15.2 A floating charge which was registered in the past in favor of banking corporations, stating that Bezeq International cannot charge its assets without consent, was removed on December 12, 2006.

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

Loans from the Company – during 2001 Bezeq International received from the Company non-interest-bearing, CPI-linked loans totaling $ 38 million the sum of which, on Bezeq International's balance sheet as at December 31 2005 and 2004 amounted to approximately NIS 113 million and NIS 169 million, respectively.

On February 1, 2006, having received the approval of management of Bezeq International that Bezeq International is able to repay the loan without such harming the running of its business, the board of directors of Bezeq International resolved to bring forward the date of repayment of the laon and to pay the sum of the loan, linked to the CPI, back to the Company on February 14, 2006 – in all, the sum of approximately NIS 173 million.

4.15.4 Bank guarantees – in accordance with the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee in the sum of NIS 9.4 million and NIS 1.4 million to fulfill all of the conditions of the license for provision of international telecommunications services; in December 2004, in accordance with the requirements of the Ministry of Communications, Bezeq International gave a bank guarantee in the sum of approximately NIS 340,000 for fulfillment of the conditions of the special license given to it to conduct a marketing trial for the provision of VOB services. As at the balance sheet date, Bezeq International has provided additional bank guarantees in a total sum of approximately NIS 3.2 million.

4.16 Taxation

See Note 8 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

4.17 Restrictions on and Superivsion of Bezeq International's Operations

4.17.1 Legislative restrictions

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

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

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

A recently introduced amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe those telecommunications services, the provision of which does not require a license. Pursuant to his

declarations, the Ministry of Communications intends to exempt the provision of internet access services.

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

4.17.1.2 Interconnectivity payments

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

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

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

4.17.1.3 Royalties

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

4.17.1.4 Standards

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

4.18 Joint venture agreements

4.18.1 In April 1997 Bezeq International signed an agreement with the communications corporation Concert for the sale of data transfer services via Concert. The corporation was set up by British Telecom (BT) and the American company AT&T and also provides uniform communications services to multinational companies. During the course of 2002, the corporation wound up and the network is currently managed by BT. Bezeq International has an agreement for the distribution of BT's services in Israel, under which Bezeq International supplies FR technology managed network services, and IP based services.

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

During the first quarter of 2005, Infonet was acquired by BT, as a result of which a restructuring took place under which the infrastructure used by the companies to provide their services to Israel was unified. At this stage, neither the acquisition or the restructuring have had any affect on the running of Bezeq International's business, nor on the sale by it of Infonet products.

4.19 Legal proceedings

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

of the tender which opened the international communications market to competition in 1995).

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

Following negotiations between the parties out of court, they reached a settlement which is currently in the process of being signed. The Company's and Bezeq International's obligations under the settlement are to pay sums that are not substantial.

4.19.2 In January 2005 a claim was filed in the District Court at Tel Aviv 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.

In April 2005, Alcatel took over management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel is standing in lieu of Tadiran for the purpose of this agreement).

4.19.3 In May 2006, Bezeq International filed an appeal with the Local Court at Tel Aviv, against a decision of the Ministry of Communications to impose a monetary sanction on the company in the sum of approximately NIS 1 million for prima facie breach of the provisions of its license regarding erotic services;

In January 2007, the court upheld the appeal in part, and the Ministry of Communications was required to refund Bezeq International the sum of NIS 387,000. Bezeq International filed an application for leave to appeal to the District Court at Tel Aviv where it petitioned for refund of the rest of the sanction paid by it.

4.19.4 In February 2007, Bezeq International filed a petition with the Supreme Court sitting as the High Court of Justice, to cancel a decision of the Minister of Communications made on January 31, 2007, to amend the policy of the Ministry of Communications regarding licensing of VOB services – under which decision, Bezeq International would only be given a license to operate domestic land line telephony services using VOB technology after the Company's market share in the field of domestic land-line telephony had fallen below 85%.

4.19.5 4.19.5 For further updates on legal proceedings, see Notes 15 and 17 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

4.20 Goals, Business Strategy and Expected Development

4.20.1 As part of the preparations for 2006, 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 Retention of Bezeq International's Profits.

4.20.1.2 Readiness for mergers in the industry and turning threat into opportunity.

4.20.1.3 Retention of Bezeq International's leadership status via market share or leading margin.

4.20.1.4 Progress on existing customer base, with emphasis on more efficient management of the churn prevention process.

4.20.1.5 Streamlining of customer service system and improving Bezeq International's concept of service.

4.20.2 **<u>Bezeq International's goals for 2007</u>**

4.20.2.1 Retaining leadership in the ISP field.

4.20.2.2 A quality merger process with BezeqCall at the employee, processes and customer levels, effecting merger synergy.

4.20.2.3 Creating loyalty by improving customer satisfaction and experience.

4.20.2.4 To continue being a focal point for excellent employees.

4.20.2.5 Improvement of effectiveness and efficiency of cross-organizational work processes.

4.20.2.6 Timing of investments as a tool for retaining the stability and growth of Bezeq International.

4.20.3 2006 was characterized by continued growth and increases in Bezeq International's revenues and operating profits.

4.20.4 In 2006, Bezeq International increased the variety of communications solutions that it provides to its commercial customers. During the course of the year, Bezeq International merged with Bezeq Gold and completed all of the proceedings for the merger with BezeqCall. Bezeq International views this field as having growth potential and plans to ground its status in this area even more.

4.20.5 2006 was characterized by a continued increase of Bezeq International's operations in the field of supply of internet access services in general, and broadband internet in particular, including a variety of value added services and Datacom operations to international customers; in this way, Bezeq International continued to reduce its reliance on revenues from international outgoing call services.

4.20.6 In 2006 Bezeq International improved its market position in all the areas of its operations. This year, Bezeq International grew significantly in the field of international businesses in which it operates.

4.20.7 During 2006, Bezeq International completed upgrading its core network. This upgrade enables the Company to offer its customers high-speed and high-quality services.

4.20.8 In 2006, Bezeq International continued to invest in its customer service system, which provides service and technical support to its business and private customers. Following this improvement in its customer services, there was an improvement in 6 out of 9 of the indices included in the Globes service index, and after total weighting, Bezeq International is ranked first on par with Netvision.

4.20.9 The above information is forward-looking and as such is not certain and might not become reality, in whole or in part. The forward-looking information is based on information that Bezeq International currently has as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results are likely to be materially different from the results estimated or inferred from this information.

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

The above forecast might not become reality at all or might become reality in part only, owing to a downturn in the Israeli economy which will reduce purchasing power in Israel, owing to regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and owing to all the other risk factors listed below.

4.21 Risk factors

Changes in exchange rates, CPI and interest rates

A Changes in exchange rates – the main currency used by Bezeq International is the shekel which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from Israeli customers. In addition, Bezeq International provides services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. In contrast, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. The changes in the exchange rates of the

currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its cash flow. To protect itself against currency exposure Bezeq International enters into hedging transactions and purchases other financial instruments.

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. Legal proceedings

Bezeq International is a party to legal proceedings including class actions which might result in its being required to pay substantial sums and in respect of those for which the company's legal counsel has assessed that it might be necessary to make use of Bezeq International's financial resources, a provision has been made in Bezeq International's financial statements as well as in those of the Company. For legal proceedings to which Bezeq International is a party, see Section 4.19 above.

Risk Factor Summary Table

	Effect of Risk Factor on Bezeq International's Activity		
	Large effect	**Medium effect**	**Small effect**
Macro risks			
Exposure to changes in exchange rates		X	
Sector Risks			
Increasing competition	X		
Investments in infrastructure and technological changes		X	
Government supervision and regulation	X		
Special risks for Bezeq International			
Exposure in legal proceedings		X	
Dependence on suppliers			X

5. <u>Multi-channel television – D.B.S. Satellite Services (1999) Ltd. (“DBS”)</u>

5.1 General Information on Area of Operations

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

This service allows for the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via small antenna dishes from which broadcasts are transmitted to a domestic decoder in the subscriber’s home and connected to the television set.

Most of DBS’s income stems from subscription fees and additional payments made by viewers.

As at December 31, 2006, DBS had 539,558 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 <u>Structure and changes in area of operations</u>

The area of broadcasts is regulated and operations in the area are effected via various broadcast licenses. The heavy regulation of the field of broadcasting includes the obligation to receive a license, the obligation to operate in accordance with the relevant provisions of the Communications Law, the provisions of the various licenses and the conditions thereof, and constant supervision of the Ministry of Communications and the Council.

Multi-channel television broadcasts have been offered in Israel since the mid-1990s, via companies which supplied cable television broadcasts. Those companies operated first under regional franchises on conditions of exclusivity, which were granted to them, and since 2002 they operated by virtue of long-term broadcast licenses which replaced the franchises. In November 1999, these companies were declared to have a monopoly in the field of multi-channel television broadcasts in the areas of the franchises in which they operated at the time, by virtue of the Antitrust Law, 5748-1988. As of the end of 2003, the cable corporations worked jointly in a number of areas of operations, under the brand name HOT. In December 2006, the cable corporations merged into a single merged cable company, HOT Cable Communications Systems Ltd., which supplies television services by cable to all of the subscribers of the cable corporations that were merged into it (the “**Cable Company**”). The Cable Company holds all of the rights in a limited partnership which owns the cable network infrastructure, including the terminal equipment and broadcast centers, and which, to the best of DBS’s knowledge, provides communications services, internet access and telephony services.

To the best of DBS’s knowledge, in 2006, the Cable Company purchased the operations of Cable-Tek Ltd., which operated in certain parts of Judea and Samaria in which Israeli law applies, as a cable broadcast corporation, which purchased the broadcast signal from the Cable Company and sells broadcasts to the residents of those areas on behalf of the local councils, which hold licenses to supply such broadcasts from the Civil Administration.

Following a government decision in August 2005 regarding the free distribution of certain television channels via a party which is to set up and operate a digital terrestrial broadcast system backed-up by satellite, hearing proceedings took place in 2006 prior to publication of a tender to set up and operate such system (see section 1.3 below).

During the course of 2006, the Ministry of Finance worked towards publication of a tender for the set-up and operation of a system for terrestrial distribution of digital radio broadcasts. As at the date of publication of this periodic report, the tender has not yet been published.

5.1.2 <u>Statutory restrictions and special constraints</u>

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

The broadcast license granted to DBS is in force until 2014. After the end of that period, the broadcast license shall be renewable for additional periods of six years each.

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

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

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

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

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

A. On October 30, 2005, the government decided to unify the operations of the Council, the Council of the Second Authority for Television and Radio, the Second Authority for Television and Radio and the Public Broadcasts Regulation Board (which provides professional and legal services to the Council) into a single unified commercial broadcasting authority, which is to be responsible for the regulation of all commercial television and radio broadcasts in Israel. To the best of DBS's knowledge, a government Bill has been prepared which is supposed to regulate this matter, however, it has not yet been submitted for voting in the Knesset plenum.

B. To the best of DBS's knowledge, for several years, the government has been looking into setting up a communications authority, which is to replace the Ministry of Communications and the authorities referred to in section A above and which is to hold all of their powers, instead of the change planned as set out in section A above.

5.1.3 Developments in markets in the area of operations

A In 2006, the trend has increased to offer consumers a "total bundle of services" which includes, in addition to multi-channel television services, internet connection infrastructure (at high speeds) as well as fixed-line telephony services (a bundle which contains these three services is also called "triple play"), and there is increasing demand for purchase of such communications service bundles.

B In August 2005, the government decided to require the Minister of Communications and the Minister of Finance to do all of the acts required such that no later than January 1, 2007, the television channels of the Israel Broadcasting Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) would be distributed to the public freely, nationwide, via a terrestrial transmission service using digital technology, backed-up by a digital satellite system. Under the above decision, various governmental authorities were required to promote and implement the decision, and in that respect, to publish a tender to choose a person to plan, set-up and operate the digital terrestrial broadcast system, and the digital satellite distribution system. DBS gave its objection to the proposal to the Minister of Finance and the Minister of Communications, as well as its objections in the event that it is realized in any event. To the best of DBS's knowledge, as at the date of these statements, the Ministry of Finance is getting ready to hold a tender to select a party to set up and operate a system to distribution channels, DBS having been told that the tender outline will take its objections into account. If the government decision set out in this paragraph is

implemented, the broadcasts of such channels shall be a partially alternative product to DBS's broadcasts.

C. In addition, in August 2005, the government resolved to require the Minister of Communications and the Minister of Finance to do all of the acts required in order to enable the public, no later than January 1, 2007, to purchase a basic television services package from the multi-channel television companies (the cable and satellite companies) including connection to the distribution infrastructure of DBS's broadcasts, and reception of the television channels of the Broadcast Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10), the Knesset Channel (Channel 99), the Educational Channel (Channel 23) and the designated channels, without the consumer being required to purchase any other services from the multi-channel television companies. To the best of DBS's knowledge, statutory amendments relating to implementation of the aforesaid decision have been integrated into the Arrangements Law 2006. DBS wrote to the Ministry of Finance asking to hold a hearing in the matter and as at the date of publication of this report, DBS is holding negotiations with the Ministry of Finance in this regard. As at the date of this report, to the best of DBS's knowledge, handling of the part of the bill relating to the basic service package has been separated from the Arrangements Law and is not being promoted.

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

5.1.4 Technological changes that significantly impact on the area of activity

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

5.1.4.2 Around the world, video over broadband content transfer services have started developing, whether in closed systems or over the internet, and these are known as IPTV (Internet Protocol Television). These services and abilities enable the consumer to watch video content (either by transferring content to all users or by transferring individually upon demand), the content sometimes being viewed via a personal computer and at other times via the television. In Israel, this service has not yet been developed in a closed network, and broadband infrastructure owners might act to launch such services in the future, and entry of another service provider into this field might adversely affect the players in the field of broadcasts. However, as at the date of this report, video content is being transferred over the internet (in both local sites designed for Israel audiences and foreign sites), and the development of this trend might substantially affect the field of broadcasts, which is currently based on special infrastructure, and might enable the supply of varied video content without needing a special infrastructure system.

5.1.4.3 Use of decoders which are able to record content broadcast on various channels onto a hard disk, known as personal video records (hereinafter: "**PVRs**"). The PVRs sold by DBS interface with DBS's electronic broadcasting timetable and enable the receipt of special services regarding the content that is broadcast, including ordering recordings in advance, recording series and suspending live broadcasts. DBS provides its subscribers with PVR decoders known by the brand name of "yesMax". Launch of PVRs to DBS subscribers is, in DBS's assessment, a partial response to the lack of VOD services to the DBS's subscribers.

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

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

5.1.5.1 Differentiation, innovation and originality in the content, branding and packaging of its broadcasts compared with the broadcasting content of its competitor, the Cable Company. These factors are reflected in the purchase and production of

content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the initiation, production and purchase of original Israeli programming. For such purpose, ongoing investment is required in the area of purchase and innovation of the content of broadcast supplied to DBS customers.

5.1.5.2 The ability to offer subscribers "personal" television services, and in particular, VOD services. This ability depends on the obtaining of regulatory consents and the amendment of legislation, and reaching a commercial agreement with Bezeq, including upgrade of Bezeq's infrastructure (see section 5.6.5F below).

5.1.5.3 The ability to offer a bundle of communications services including television services and other services such as telephone services and internet services.

5.1.5.4 Differentiation at the customer service level provided to DBS subscribers by the customer support and customer service setup, which constitutes a critical success factor in DBS' ability to retain customers in a competitive market.

5.1.6 Principal entry and exit barriers

5.1.6.1 The main entry barriers into the area of operations are: (a) the need for appropriate licenses under the Communications Law; (b) the immense investments required to be made by carriers in the area of operations, including for the purpose of setting up appropriate infrastructure and purchasing and producing content; (c) saturation of the broadcast market.

Recently, some of these entry barriers have begun to be eroded as a result of technological developments which enable the transfer of content over internet infrastructure (such as IPTV – see section 5.1.4.2 above).

5.1.6.2 The principal exit barriers are: (a) the regulatory barrier – termination of operations under the broadcast license depends on a decision of the Minister of Communications to cancel the license prior to the end of the license term, under the conditions set out in the license, including arrangements for ensuring the continuation of broadcasts and services and reduction of harm to subscribers. The licensee is required to continue providing the services under the broadcast license until the date prescribed by the Minister or until completion of such arrangements as the Minister may instruct, whichever is the later. (b) long-term contracts with suppliers.

5.1.7 Alternatives to and changes in products of area of operations

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

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

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

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

5.1.7.3 DVD libraries.

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

The concentrated and complex ownership structure in the areas of content, communications and infrastructure in Israel is likely to cause groups throughout the chain of production, packaging and supply of content to move into positions of control. The Cable Company which, together with the corporations related to it, has a broad deployment of advanced broadband infrastructure, markets and sells a package of services including multi-channel television services, high-speed internet infrastructure, and fixed-line telephony. Sale of the service page with these three types of communications services (known as 'triple play') whilst DBS does not offer a similar package, constitutes a principal component in differentiating the offer to potential subscribers.

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

5.2 Products and Services

DBS's broadcasts provide its subscribers with a wide variety of channels: Around 157 different video channels (of which 30 are pay per view channels) and another 20 radio channels, 30 music channels and 21 information channels (including portals), and interactive services.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport package and the science and nature package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is acting to obtain approval to launch VOD services (See Section 5.6.5F below).

DBS sells its subscribers decoders, which are necessary in order to record its broadcasts. DBS also sells PVR decoders (see section 5.1.4.3 above).

5.3 Revenues and Profitability of Products and Services

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

	2006	2005
Revenues	1,356	1,222
Gross Profit	216	150

5.4 New Products

DBS has the ability to supply VOD services to its subscribers via DSL infrastructure. However, launch of the service requires the receipt of regulatory consents, which have not yet been received, and according to the Ministry of Communications position, legislative amendment, and the consent of the Company (including infrastructure upgrades that Bezeq will be required to effect) – see section 5.6.5(f) below.

5.5 Marketing and Distribution

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

5.5.1 Sales people in the field working to recruit subscribers.

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

5.5.3 External resellers of Bezeq's services working on the basis of agreements with DBS.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 Competitors in the broadcasting market

DBS is in principal direct competition, as set out in section 5.1.1 above, with the Cable Company.

DBS estimates its share of the multi-channel television market as at December 31, 2006, to the best of its knowledge, at around 37% of total subscribers.

5.6.2 Broadcasting characteristics of the competitors

DBS's competitor is the Cable Company. For the operations of the Cable Company see section 5.1.1 above.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the Cable Company transmits its broadcasts to most of their subscribers using a digital broadcasting method and the above-mentioned tiering, while for the remainder it uses an analog broadcasting method, which does not allow viewing electronic broadcasts or tiering and supply of 'personal television' but rather, of one identical channel package (for further implications of this difference, see Section 5.6.4 below).

5.6.3 Characteristics of the current competition

After DBS achieved high rates of growth in subscribers during the first years of its operations, inter alia due to temporary regulatory concessions given to it and a considerable technological gap, together with high churn rates amongst subscribers of the Cable Company, in 2006, there was a relatively slow increment in the number of DBS subscribers (in 2006, the number of subscribers increased by approximately 20,000).

	2006	2005
Increase in number of subscribers	18,887	50,177
Rate of growth	3.6%	10.7%

At present, the competition in the broadcasting sector is focused on content, on the channel packages offered by the broadcasting companies, on prices of channels, on packages and on service (including VOD services which are provided by the Cable Companies). Competition is also characterized by offers of other communications services as part of the service package (see section 5.6.5G below). DBS invests efforts and resources both in marketing its services to the subscribers of its rivals as well as in purchasing special, quality content which it includes in its basket of services and broadcasts.

5.6.4 Positive and negative factors regarding the competition

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

A DBS makes use of advanced digital technology, which contributes to picture and sound quality; enables a fast and convenient user interface for subscribers when watching broadcasts; enables translation of the broadcast content into foreign languages and the additional of dubbing into other languages (such as into Russian), at the subscriber's election (in most of the DBS's "home channels"); and enables the user to choose a language interface from four options (Hebrew, English, Arabic and Russian). In addition, DBS transmits wide screen broadcasts in a variety of channels which allows subscribers to watch broadcasts in wide screen format (which is similar to the format used in cinemas) on television sets. DBS broadcasts a number of channels using sound technology known as Dolby Digital (which is only supported by some of the decoders).

B DBS's broadcasts are transmitted via satellite, and therefore the broadcasts can also be received in remote or isolated areas in which there is no access to cable infrastructure.

C. The quality and variety of content broadcast by DBS to its subscribers.

D. The level, quality and availability of DBS's customer service system, both telephone service and technical service.

F. Accessibility and fast installation of equipment for receiving DBS broadcasts for customers living in buildings that are not connected to multi-channel television infrastructure in remote or isolated areas.

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

A Inferiority of regulatory infrastructure in terms of launching of services that require high-speed bi-directional infrastructure, in particular VOD services (See Section 5.6.5F below).

B. Some of the Cable Company's customers are customers of analog cable systems (see Section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the Cable Company has much greater access to them since the analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.

C. The directives issued by the administration of the Ministry of Communications, relating to the bi-directional transfer of subscribers between DBS and the Cable Company and use of the infrastructure installed in the homes of subscribers, require 36 hours' notice before disconnection of an existing subscriber of the Cable Company (and vice versa in the case of disconnection of an existing DBS subscriber). The Cable Company can exploit this time frame to make special offers to existing subscribers about to leave it for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the Cable Company, the administrative orders stipulate that payment must be made thereof (and vice versa). However, as at the date of this report, neither the Cable Company nor DBS are in full compliance with the administrative order. For this and the hearing being conducted by the Ministry of Communications with respect to internal wiring, see section 5.14.3 below.

D. The Company's license imposes restrictions on the structural separation between the Company and its subsidiaries and certain affiliated companies, among them DBS. The longer these restrictions remain in force, and at the same time no similar restrictions are imposed on the Cable Company (and telephony and internet corporations affiliated to them), the more they will harm the DBS's ability to compete (for further details regarding these restrictions, see Section 2.16.2B above).

E. DBS has inferior infrastructure which does not permit transfer of telephony and internet services over Bezeq's infrastructure or the ability to offer a "bundle of services" on the basis of Bezeq's infrastructure, contrary to the Cable Company whose infrastructure does permit supplying such services. This inferiority is even more pronounced given the regulatory restrictions imposed upon DBS and Bezeq.

F. Regulatory restrictions of structural separation, including restrictions in the field of joint marketing of products and services, between the Company and its subsidiaries including DBS, restrict DBS's operations. So long as these restrictions remain in force, and at the same time, there are no other similar restrictions on the Cable Company (and a corporation related to it in the field of telephony) harm DBS's ability to offer a bundle of services at a competitive price. In addition, there are regulatory restrictions imposed upon Bezeq with respect to the injection of funds into the Company. Since the Company is a shareholder of DBS, DBS is subject to the restriction on obtaining a license to supply telephony services over broadband internet (VOB), whilst telephony services are offered to subscribers of the Cable Company.

G. DBS has significant expenses involved in leasing space segments, which are necessary for the purpose of providing DBS's broadcasts.

H DBS views the development of IPTV services in Israel as being a factor that might adversely affect its competitive standing in the broadcast field, including entry of additional competitors into the field of multi-channel broadcasts.

5.6.5 <u>Principal methods for coping with competition</u>

The following are the main methods used by DBS to deal with competition in the field of broadcasts:

A Branding – cultivation, promotion and differentiation of the "yes" brand;

B Content – DBS acts to purchase, produce and broadcast high-quality, innovative and varied content, creating differentiation of its content;

C. Service – DBS emphasized its customer service and technical service systems;

D. Technology – continuing investments in technological capabilities and quality of DBS's broadcasts; emphasizing technological innovation;

E. PVRs – since DBS views the supply of "personal" television broadcasts as an integral part of the services provided by those operating in the broadcasting market in this modern era, and a significant component of the total bundle of services offered to subscribers, at the beginning of 2005, DBS launched PVR decoders under the brand name yesmax. As at the date of the report, DBS is investing marketing resources to increase the rate of penetration of its PVR decoders among its subscribers. To the best of DBS's knowledge, the Cable Company also sells PVR decoders to its subscribers.

F. VOD – whilst the Cable Company commenced providing VOD services to its subscribers at the beginning of 2005, as at the date of this report, DBS has not yet launched such services.

Due to the inferiority of infrastructure as referred to above, DBS applied to make use of the fast bi-directional line owned by Bezeq – DSL (Digital Subscriber Line) and to provide its subscribers with VOD based on that infrastructure, since a technological experiment done on that infrastructure was successful towards the end of 2004. This use of DSL infrastructure requires the consent of the Ministry of Communications, which requested to examine the need to amend the Law regarding the scope of services that a satellite broadcast licensee may supply under the Communications Law and the prohibition imposed upon it in the Communications Law against providing 'cable services', as well as the policy regarding the provision of VOD services over Bezeq's DSL infrastructure. Following applications by DBS to the Ministry of Communications to approve supply of the services to its subscribers on a commercial scale, on October 11, 2005, DBS received the response to the general counsel for the Ministry of Communications stating, *inter alia*, that receipt of a commercial license to provide such services would require statutory amendments and that the Ministry of Communications has not yet formulated its policy regarding the application. Therefore, as the response states, DBS's application for a commercial license for the provision of the aforesaid services, and a license to perform experimental marketing, is not possible at this stage. Further to this position, the Ministry of Communications invited persons in the communications industry, including DBS, the Cable Company and internet access licensees, to respond to the issue (hereinafter: the "Hearing"). On December 25, 2005, DBS gave its response to the hearing, in which it set out, *inter alia*, the importance and urgency of providing the consent for commercial supply of VOD services to its subscribers.

In January 2007, the Ministry of Communications published a hearing on this matter, with respect to the policy formulated by an internal team at the Ministry of Communications. The policy statement notes, *inter alia*, that the Ministry of Communications examined DBS's application and decided that there are grounds for permitting DBS to supply VOD services over Bezeq's ADSL infrastructure, subject to the restrictions set out in the hearing document, including a prohibition against offering VOD services not in the context of DBS's (and the Cable Company's) total services, and restrictions to be imposed on Bezeq, as owner of the infrastructure (including a prohibition on Bezeq against providing such services itself, and implementation of egalitarian access to all of the users of its network for the purposes of VOD services). The Ministry of Communications further noted that in light of the aforesaid, it intends to act to amend the Communications Law, so as to enable the council to allow DBS to supply VOD services, even not via satellite. On January 14, 2007, the Ministry of Communications published a memorandum of a government bill to amend the Communications Law so that the Ministry of Communications, following consultation with the Council, should it find that there is a real difficulty in supplying such services via satellite, may permit DBS to supply them other than via satellite. A private member's bill submitted in October 2006 and authorizing the Minister of Communications to grant the requested license is also pending. On January 30, 2007, DBS submitted its position in this additional hearing to the effect that the Ministry must grant the Company the requested license. On March 15, 2007, the Ministry of Communications published a final position paper on VOD. In this regard, see section 2.6.5 below. On March 18, 2007, a draft of the Law in this matter was approved by the Ministerial Committee on Legislation. The Bill allows content suppliers including DBS to supply VOD services (for DBS, as a licensee for satellite broadcasts as set out above, regarding the memorandum for the Bill).

In February 2007, DBS applied to the State Prosecution Office attaching a draft petition regarding the supply of VOD services. DBS noted that it had exhausted its attempts to receive a license from the Ministry of Communications and at this stage, it had no choice but to petition the High Court of Justice requesting that the court grant it a remedy, and therefore, prior to taking such steps in the High Court, it requested that the State Prosecution Office conduct an investigation as to its claims and requests, set out in the draft petition, in the hope that such investigation would make the need for filing the petition unnecessary. As at the date of the report, the State Prosecution's response has not yet been received. DBS is considering petitioning the High Court of Justice requesting that it instruct the Minister to grant the Company a VOD license forthwith. As stated above, according to the position taken by the Ministry of Communications, set out above, is that even if it is decided as a matter of policy that the application be approved, the launch of VOD services will only be permitted after amendment of the Law in this regard, exception within the context of a minimal technological trial which DBS has recently been conducting under a trial license granted to it in September 2006.

In DBS's opinion, approval of its request to launch VOD services over DSL infrastructure shall constitute a response to the competitive need to launch these services. However, connection of a subscriber to the DSL network is a necessary precondition for provision of the VOD service. In addition, to the best of DBS's knowledge, a considerable share of its subscribers will not be able to receive these services before an upgrade of Bezeq's infrastructure, and the rest of them will only be able to receive the service in a limited fashion until the infrastructure is upgraded. Likewise, launch of the service depends also on Bezeq's consent to supply it under conditions that will enable DBS to be able to provide the service. On the other hand, in DBS's view, the ongoing delay in receiving the consent to provide the VOD service is causing severe harm to its ability to compete with the Cable Company. As at the date of this report, the commercial conditions between DBS and Bezeq regarding launch of VOD services have not yet been concluded.

G. "Bundle of services" – as set out in section 5.6.5G above, a trend has developed in the field of broadcasts of offering a bundle of communications services as a marketing measure to recruit customers and to retain them, and there is an increasing demand on the part of consumers and potential consumers to receive a total bundle of services enabling them to receive multi-channel television services, high-speed internet connection infrastructure services and fixed line telephony services at lower prices than the prices paid for purchase of each of these services separately.

As a result, DBS currently sells a service package, together with Bezeq, which includes broadcasts and infrastructure to connect to high-speed internet services. However, due to regulatory restrictions imposed upon Bezeq with respect to structural separation between it and its subsidiaries and certain related companies, including DBS, contrary to the Cable Company, which sells its subscribers a triple bundle of services, under which it can also reduce the prices for the bundle of services, DBS is unable to offer a similar bundle.

In July 2006, the Director General of the Ministry of Communications wrote to DBS requesting to terminate its subscriber campaign which it is alleged included a proposed bundle of services, which included, *inter alia*, installation of a Bezeq telephone line at a lower price than that set out in the Communications (Telecommunications & Services) (Payments for Telecommunications Services) Regulations, 5766-2006, in a manner that gave rise to a suspicion of breach of DBS's license, which, so it is alleged, prohibits it from dealing in telephony. DBS was also required to provide information regarding the campaign. DBS replied to the letter, rejecting the Ministry of Communications' claims. DBS also noted that the installation of telephone lines was being done by Bezeq alone, and not be DBS, which is only acting as a dealer for the service, and therefore, its actions do not amount to a breach of the provisions of the law or its license, and they do not require a license. Without derogating from these claims, DBS ceased making this offer to its subscribers.

H. VOB – in addition, DBS acted to obtain a license for the provision of telephony services via broadband access (voice over broadband) (hereinafter: "VOB") such that it will be able to sell its subscribers, alongside television and internet services, fixed-line telephony services as well. In January 2007, the Minister of Communications published the Ministry of

Communications policy regarding the grant of licenses for the supply of VOB services, in which it was prescribed, *inter alia*, that DBS would not be entitled, at this stage, to receive a license to supply VOB services until Bezeq's market share in the field of domestic fixed-line telephony fell below 85%. However, the Minister decided on an investigation point in a year's time, at which the possibility of granting the Company a VOB license would be examined if DBS's competition status had worsened, and taking into account the competition in the field of domestic fixed-line telephony. However, DBS is not prohibited from marketing the VOB services of another licensee and in a notice published by the Ministry of Communications to the public upon the making of this decision, it was even noticed that in order not to harm the possibility that DBS might market a bundle of services including telephony services using VOB technology, similar to the bundle marketed by the Cable Company, the Ministry is allowing DBS to market such a bundle as aforesaid together with other VOB suppliers. Immediately upon receipt of the decision, DBS wrote to the director general of the Ministry of Communications, asking to receive all of the data and documents that were before the Minister when he made his decision, emphasizing that this was a decision with difficult implications and that on the face of it, it was not clear what had brought it about. Following this letter, the DBS received a number of documents, but not all of the documents that it had requested, and it was also not given any confirmation that the documents transferred were all of the relevant documents. In light of that, DBS once again contacted the Ministry of Communications on February 27, 2007 and on March 6, 2007, and gave notice that in light of the severity of the harm, it was considering petitioning against the policy decision to the High Court of Justice, and that if it did not receive additional documents as it requested in its letters within 10 days of the date of such letter, it would be forced to rely in its petition on the partial material that it was given. As at the date of this report, no response to the above letter has been received and DBS is considering petitioning against the policy decision to the High Court of Justice.

5.7 Property Plant & Equipment

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re'em Junction, leased space segments on the Amos 1 and Amos 2 satellites and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

5.7.1 Rental of structures

DBS's main offices, including its management, broadcast center and other operations departments, are in three buildings in the Eastern Industrial Zone at Kfar Saba, in an area covering approximately 9,701 sqm, alongside which there is a parking lot and adjacent facilities: An area of approximately 7,077 sqm (in which the broadcast center is situated) are leased by a third party, in accordance with a memorandum of understanding dated May 1999. The lease ends in November 2009, and the Company has an option to extend the term of the lease by 10 more years under the same conditions. The Company has a right of first refusal to purchase the premises from Azorim, should such be put up for sale; an area of approximately 1,994 sqm in another adjacent building is leased by a third party, the term of which lease ends in July 2008.

In addition, DBS runs two operational centers, one being in the Nesher Industrial Zone (some 1,322 sqm in area, which is leased by a third party until May 2008) and the second in the Industrial Zone at Kanot (some 1,487 sqm in area, which is leased to a third party until July 2011), and thee are used as technical service and sale centers for subscribers in the north and south of the country; in addition, nation-wide telephone service centers operate from them.

5.7.2 Terminal Equipment

DBS installs a receiver dish and other terminal equipment in subscriber homes, including decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see Section 5.15.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are

made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them.

5.8 Intangible assets

5.8.1 Licenses

DBS owns the following licenses:

5.8.1.1 Broadcasting license valid until January 2014 – this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see Section 5.14 below).

5.8.1.2 License for satellite television broadcasts in the Judea and Samaria region valid until January 2009, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judea and Samaria region.

5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until January 2014 or until the end of DBS's broadcast license, whichever is the earlier. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

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

5.8.2 Intellectual property assets

A. Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered on the Register of Trademarks. The main trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

B. Copyright organizations

DBS owns the copyright to the various television content it produces as well as the copyright usage licenses owned by third parties for the purpose of broadcasting and integration into the framework of its subscriber broadcasts. The broadcast of content in which DBS owns broadcast rights involves the payment of royalties to the owners of intellectual property – i.e., copyright and performers rights in sound recordings for actual broadcasting, including under the Copyright Law and the Performers and Broadcasters Rights Law, 5744-1984. Payment of royalties as aforesaid is done via a number of organizations that operate in Israel, which collect the royalties owing to the owners of the intellectual property rights and in return provide the broadcasting entities with blanket licenses. For some of these licenses which represent principal royalty payments, the final sum owing from DBS for uses under the license is prescribed in accordance with the final sum paid by the Cable Company to the licensee for every subscriber, either in the case of an agreement between them and the licensee or in the event of a judicial ruling on a dispute between the parties, the consideration owing from DBS being no less, in any event, than that paid currently under the license. Payments by DBS under these licenses are based mainly on a fixed payment and sometimes on various pricing methods, including those that depend on the number of subscribers as aforesaid.

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

DBS's costs to such collection organizations in 2006 amounted to approximately NIS 13 million.

C. Investment in content

D BS purchased broadcasting rights for 2006 from various owners of copyrights to intellectual property for purchased content. DBS's rights to use such content are extremely important for its operations, since its main broadcasts are via use of the content of third parties, and via integration of acquired content and content used by DBS in order to produce programs and previews. DBS from time to time grants rights of use in television content produced or purchased by it to franchisees of the Second Television and Radio Authority, for the purpose of re-broadcasting such content.

D. Costs of acquisition of subscribers.

See Note 3 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

E. Software

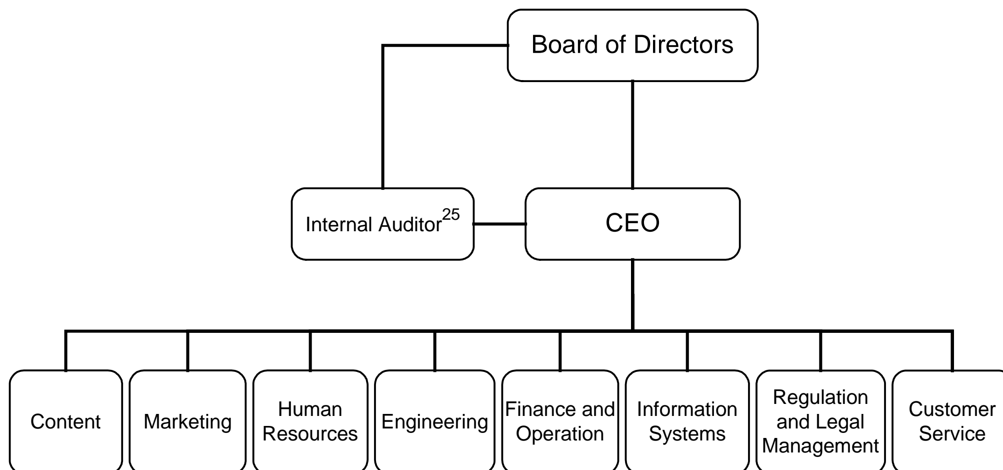
See Note 3 to the Company's financial statements for the year ended 2006, which are included in this periodic report.

5.9 Human Resources

5.9.1 Organizational structure

DBS has 8 departments, each one headed by a VP who is a member of management of DBS. DBS's departments are:

marketing, customers (including recruitment of customers and service), content, engineering, finance and operations, human resources, regulation and legal administration, and information systems:



[24] The auditor is an external auditor.

5.9.2 DBS personnel by division

Division	Number of Employees		
	As at December 31, 2004	As at December 31, 2005	As at December 31, 2006
Marketing Department[25]	24	17	21
Sales Department	366	346	289
Customers Division[26]	1,142	1,050	1,016
Content Department	39	48	52
Engineering Department	61	69	72
Finance and Operations Department	90	103	95
Human Resources Department[27]	9	8	9
Regulation and Legal Administration Department	1	1	1
Information Systems Department	5	24	54
Total	1,737	1,674	1,609

5.9.3 Training and development of human capital

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

In 2005, DBS consolidated its training and instruction center consolidating the three main training tracks, which is used as a training center for all DBS managers and employees.

DBS trains some 1,000 employees every year.

5.9.4 Organizational change

In 2005, the Marketing and Sales Departments were merged into one Department. The Customer Service and Technical Sales Departments were also merged into the Customers Division. In 2006, the Sales Department was merged into the Customers Division, and the Marketing Department became an independent department.

5.9.5 Employee remuneration schemes

DBS has a remunerations plan based on targets for senior management of DBS. For the options to DBS office bearers see Note 26 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report.

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 section 5.8.2 above).

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[25] In 2004, there were separate Marketing and Sales Departments, which were unified in April 2005 into a Marketing and Sales Department. At the end of 2006, the Company's Sales Department was integrated into the Customers Division, and Marketing went back to being an independent department (which accounts for the increase in employees in the Customers Division as at December 31, 2006, and the corresponding decrease in the number of employees of the Marketing Department as at the same date).

[26] In 2004, the Customers Division was divided into the Technical Logistic Service Department and the Customer Service Department, and these departments united into the Customers Division in April 2005. At the end of 2006, the Sales Department was also brought into the Customers Division.

[27] In January 2007, the training sections of the Company's various departments was unified into central administration as part of the Human Resources Department.

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of original productions made for DBS which, under purchase agreements, may be broadcast a number of times or which may be sold to third parties are deemed to be part of DBS's broadcast rights inventory, and the cost of them is amortized over the period of their expected use, or in accordance with the estimated number of future screenings of such programs, but in any event, are amortized in full upon expiration of the broadcast rights under the contract.

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for the channels known as "Channel 5" and "Channel 5+" from the provider of these contents (JCS). There is also dependence on the other supplier of sport content, Charlton Ltd.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with two owners of the rights to the space segments (see Section 5.15.2 below).

DBS is dependent on the continuing regular availability of the space segments (see Section 5.19(E) below).

As at the date of this report, DBS pays the current rental on space segments on the Amos 1 satellite, and makes partial payments on account of the rental debt for previous periods the time for payment thereof to the Israel Aviation Industry has passed (due to assignment of the right to receive rental from HLL to the IAI). In light of DBS's arrearage in payments prescribed under the above agreement, IAI wrote to DBS in March 2006, requesting the payment of any debt, and the parties are negotiating on this. In addition, DBS and HLL are in dispute as to the amount of annual rental owing to HLL for lease of space segments on the Amos 2 satellite, which has not yet been regulated, DBS paying the sums that are not in dispute only, and paid HLL an additional one-time sum which constitutes part of the sums that are in dispute. In March 2007, HLL gave notice to the Company that if the sums that it claims are owing to it are not paid, it shall submit a claim to the arbitrator in accordance with the agreement between the Parties. In this regard, see Note 18 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report.

C. Digital decoders

DBS purchases digital decoders for the purpose of receiving and decoding its broadcasts, which are encrypted, at the customers' home. DBS is dependent upon the supplier from which the decoders are purchased. Replacement of this supplier with another supplier would not entail material extra cost, but the replacement would require a significant preparation period to adapt the decoders of the replacement supplier to DBS' broadcasting and encryption system. For a description of the agreement with this supplier 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 upon the regular provision of these services.

5.11 Working capital

5.11.1 Accounts Receivable

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2006, customer credit amounted to approximately NIS 149,181,000 net.

5.11.2 Supplier credit

The average supplier credit period in 2006 was 146 days.

5.11.3 Deficit in working capital

As at December 31, 2006, DBS's deficit in working capital amounted to NIS 1,550,754,000.

In 2005 and 2006, DBS reduced its working capital deficit.

5.12 Financing

5.12.1 Average interest rate for loans

5.12.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

5.12.1.2 CPI-linked non -interest bearing loans.

5.12.1.3 CPI-linked loans bearing annual interest of 5.5%.

5.12.1.4 CPI-linked loans bearing annual interest of 11%.

5.12.1.5 Institutional bodies

Loans provided to DBS by institutional bodies in 2005 are linked to the consumer price index and bear interest at an annual rate of 11%. Loans provided to DBS by institutional bodies in 2006 are linked to the consumer price index and bear interest at an annual rate of 8%.

5.12.1.6 Banks

Short-term credit – the average interest rate for this credit for 2006 is 7.83%.

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

Loans based on prime interest rates where the average interest rate for 2006 is 7.88%.

CPI-linked loans where the average interest rate is 6.64%.

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 and minimum supplier credit.

E. Minimum targets for coverage of the bank debt and debt balances.

F. Maximum overall finance requirements.

G. Maximum churn rate.

The values for meeting the financial criteria are variable and are measured quarterly. Non-compliance grants the banks the right to demand early repayment of the loans and the right not to award DBS any further unused credit line. During 2005, the banks completed providing the entire credit limit to which the Company was entitled under the financing agreement (apart from the sum of approximately half a million shekels) in return for the

provision of shareholders' loans by the shareholders of DBS in the rates required under the financing agreement (apart from shareholders loans which the banks waived under the amendment to the financing agreement dated December 2005, as replaced in the schedule to the financing agreement dated May 2006 (in this section: the "**amending document**"). Under the amending document, the banks confirmed that actual investments by shareholders in DBS by the end of 2005, despite certain deficits therein compared with the values prescribed in advance in the financing agreement, do not constitute a breach of the financing agreement. Under the amending document, the bank credit limit was increased (in this section: the "**additional credit**"). Under the amending document, the additional credit is intended to be repaid by the end of 2008, in the installments set out in the amending document, however, in the event of injection of shareholders' equity into DBS by its shareholders, or external credit (in such sum and on such conditions as require receipt of the banks' consent under the financing agreement) before the date of repayment of the additional credit, DBS is required to repay the additional credit early, in the amount of the sum injected. It was further agreed that the interest rates on the bank credit would be increased until full repayment of the additional credit.

During 2006, DBS began gradual repayment of the bank credit taken by it, up until full repayment in 2013. As at December 31, 2006, DBS is in compliance with these conditions (following relief granted to it in December 2006). However, DBS's management does not expect that it will be in compliance with the aforesaid conditions in 2007. Given this forecast, loans from the banking corporations are presented under short-term liabilities.

In light of the forecasts of DBS's management regarding the business results for 2007, DBS applied to the banks in order to plan and adjust targets prior to full repayment of the bank credit. As at the date of approval of the financial statements, the aforesaid conditions have not yet been concluded. DBS is also negotiating with the banking corporations to resolve a dispute regarding insurance undertakings set out in the financing 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 relating to the shareholders loans provided to DBS by the Company, including their inferiority to bank credit (and to debentures issued to the public, if any), and restrictions regarding the repayment of them prior to full repayment of the bank credit, or taking into account certain shareholders loans before some of the bank credit is repaid, as set out in the financing agreement.

D BS is bound by mandatory repayment of sums that it receives with respect to the placements of shares or debentures to the public, sale or transfer of property and certain cash surpluses of DBS, on the conditions and at the rates set out in the financing agreement. DBS may, voluntarily, effect early repayment sums received with respect to placements of shares or debentures to the public, which may remain after the aforesaid mandatory repayment, on such conditions and at such rates as are set out in the financing agreement.

The financing agreement also sets out provisions regarding various reports which DBS is required to provide to the banks, including with respect to examination of its compliance with financial conditions.

The financing agreement sets out a list of events which amount to breach thereof, and which entitle the banks, under the conditions set out in the financing agreement, to make the bank credit immediately repayable.

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

DBS shareholders, with the exception of the Company, charged the DBS securities in their possession in favor of the banks, to secure the amounts which the banks made available and will make available to DBS. Most of the shareholders also charged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that these loans would be inferior to the bank credit. In view of the restrictions on the Company's ability to charge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Note 13 to the Company's financial statements for the year ended December 31, 2006, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders charged in their favor. The Company also gave an undertaking to sell its shares if the shares charged by the banks are sold. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

As at the date of this report, DBS is not in compliance with all of its undertakings under the financing agreement to take out insurance with respect to its operations and assets, including with respect to the duty to take out satellite failure insurance for the satellites on which DBS leases space segments for the purpose of its broadcasts. DBS is negotiating with the banks for relief with respect to its insurance undertakings, which will enable it to comply with these undertakings.

In addition, arrears in DBS's payments to the Israel Aviation Industry (as set out in section 5.10.1 above), constitutes a prima facie breach of the financing agreement, however, the banks have allowed DBS not to deem the demand by IAI for repayment of the debt, and non-payment of the debt, as a breach by DBS of the financing agreement, provided that by March 31, 2007, the parties reach a written arrangement with the IAI regarding repayment of such debt, and that during the period prior to March 31, 2007, IAI does not institute any measures for collecting its debt as aforesaid.

As at the date of approval of the financial statements, DBS is acting to obtain additional sources of finance in order to enable it to realize its goals for the coming year. If these sources are not obtained, DBS shall act in accordance with its alternative business plan, which does not require additional sources of finance to those already existing.

5.12.3 Credit amounts received in 2006

In 2006, DBS received a loan from a number of related institutional parties in the sum of NIS 50 million (principal). In December 2006, DBS received a loan in the total sum of NIS 50 million (principal) from a number of related institutional parties. The loan is linked to the CPI and bears interest at an annual rate of 8%, the principal of the loan being expected to be repaid in three annual installments, commencing on December 31, 2013, and the interest on the loan to be paid in regular quarterly installments, however, the lender has the right to receive repayment of the loan prior to the making of any payments to DBS's shareholders, including dividends, management fees and repayment of shareholders loans, but not including payments to suppliers. DBS has an option for a fixed period to take out another loan in the amount of NIS 50 million at agreed interest, provided that it complies with a financial goal prescribed in the loan agreement. This credit is inferior in terms of repayment to the bank credit, however, DBS, the banks and the lenders agreed that the loan could be repaid in accordance with the repayment table (even prior to repayment of the full bank credit) so long as the banks have not given a declaration regarding the occurrence of an event of breach with respect to the financing agreement

and/or notice of the making of the bank credit immediately repayable. It was also agreed that this loan could be repaid on account of DBS's right to repay the shareholders' loan provided and to be provided by the shareholders in DBS, after April 1, 2004.

DBS and/or its shareholders have not given any guarantee and/or surety in assurance of repayment of this loan.

5.12.4 The Corporation's credit facility

DBS's credit facility is approximately NIS 1,430 million and it is used for the current operation and the granting of bank guarantees for DBS's operations. As at December 31, 2006 DBS has utilized NIS 1,400 million of this credit.

The credit taken by DBS from institutional entities (at a total rate of NIS 100 million) in 2005 was received under loan agreements dated March 2005 and April 2005. This credit was taken on inferior repayment conditions compared with the bank credit, apart from exceptions that are similar to those which apply to the shareholders' loans provided by shareholders of DBS after April 1, 2004. In assurance of repayment of the loans to institutional entities, an undertaking was given by the Company (which is conditional, *inter alia*, upon DBS having a positive worth), as set out in Note 19 to the financial statements of the Company for the year ending December 31, 2006, which are included in this periodic report, and the banks that are financing DBS's operations agreed that in the event of exercise of the Company's shares in DBS by them, the financial entities shall be entitled to a proportionate part of the receipts of such, at the rate set out in the agreements. The institutional entities were also given an option to provide loans in an identical sum to that provided by them provided that the sums of the loans are required under DBS's business plan, and this option is exercised by them in full. Contemporaneous with these agreements, appropriate amendments were signed to the financing agreement with the banks that finance DBS's operations, the principal point of which is viewing the loans received from the institutional entities as being shareholders loans, as aforesaid.

5.12.5 Need for raising of additional sources of capital

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

For details regarding the shareholders' loans from its shareholders and for the position taken by the Ministry of Communications regarding the provision of shareholders loans by the Company, see section 5.19.3 below and Note 32 to the financial statements of the Company for the year ended December 31, 2006, which are included in this periodic report.

5.13 Taxation

See Note 8 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

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

5.14 Restrictions on and Supervision of the Corporation

5.14.1 Subjection of activities to specific laws

DBS's operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The above legislation, secondary legislation, resolutions of the Council and administrative directives have a substantial impact on DBS and its operations. Likewise, legislation and secondary legislation in the field of communications in general has a substantial impact on DBS.

Restrictions are applicable to DBS by virtue of the Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations , 5758-1998

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

The Telecommunications (Television Broadcasts via Satellite) (License Fee and Royalties) Regulations, 5759-1999 (hereinafter: the "**Royalty Regulations**") as amended in August 2006, provide the rate of royalties and the broadcast license fees to be paid by a licensee for satellite broadcasts to the State. Under those regulations, DBS owes royalties in a rate of 3.5% of its revenues from the provision of broadcasting services in the years 2004 and 2005, in the rate of 3% for 2006 and in a rate of 2.5% for 2007. The royalty rate will be 2% in 2008, 1.5% in 2009 and 1% from 2010 onwards.

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

In accordance with the requirements of the broadcasting license and regulations determined by the Council, in 2004 and 2005 DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees. According to a decision of the Council dated September 2005, the rate of investment of DBS's revenues in local productions during the years 2006 and 2007 will stand at 8% of such revenues.

Under the requirements of the law and the license, DBS is required to allow independent channel producers under section 6EEE of the Communications Law to make use of its infrastructure in order to distribute transmissions to its subscribers, in return for payment to be set out in an agreement, and in the absence of any agreement, in consideration for payment to be prescribed by the Minister, upon consultation with the Council.

DBS complied with its duty regarding original productions for 2004 (including the proportionate part of supplementation of past debts), apart from non-substantial deviations in the sub-division for various classes, which the Council instructed DBS to remedy during 2005. In September 2006, the Council confirmed that DBS was in compliance with its original products duty for 2005 (including the proportionate part of supplementation of past debts) apart from non-substantial deviations for the sub-division for various classes.

5.14.2 Operations subject to broadcasting license

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

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

5.14.3 Principal restrictions by virtue of the law and broadcasting license

The Communications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards,

which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation; an encumbrance placed on any of the broadcasting license's assets shall not be realized unless as determined by the Minister of Communications; DBS's broadcasts under the broadcasting license, and the scope thereof, are subject to the Law (for the statutory restriction on VOD services, see Section 5.6.5F above); a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more or in any percentage resulting in a person becoming an interested party or controlling party in the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to said shares listed on the Stock Exchange); reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties thereto, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the Cable Companies) except for the transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts.

The broadcasting license also contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications; conditions regarding whether the terminal equipment installed by DBS complies with standards.

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

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

DBS is also required to transmit the television and radio (FM) channels lawfully broadcast in Israel which can be received from the air, ground or satellite, the educational television channel and "must carry" broadcasts to its subscribers. Under the provisions of the Law, DBS currently transmits broadcasts of two "must carry" channels, the music channel ("Channel 24") and the Russian-language channel ("Israel Plus"), in return for a sum to be set by the Minister of Communications (as at the date of publication of this report a fixed payment had not yet been set for the transmission of the "must carry" channel), and also two independent licensees "Nature of Things Channel" and "Clicka" channel which collect subscriber fees directly from their customers.

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

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

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

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

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

At the beginning of March 2006, the Cable Company gave notice to the director general of the Ministry of Communications that in light of DBS's breaches of the administrative order, it was ceasing to accept disconnection notices sent to it by DBS, and indeed, the Cable Company ceased accepting any notices under the administrative order, including connection plans and termination notices. DBS dismissed the claims made by the Cable Company and argued that by refusing to receive notices from DBS, not only was the Cable Company in breach of the administrative order, it was also in breach of its license and of the agreements via which it had contracted with its customers, since it continued charging subscribers a subscription fee despite knowing that such subscribers had disconnected from their broadcasts. DBS also demanded that the Ministry of Communications order the Cable Company to stop charging subscribers immediately upon receipt of notice of disconnection. Following these letters, further correspondence was conducted between the Cable Company and DBS, in which each party repeated its claims. As at the present date, the Ministry of Communications has not yet commented on the issue, and the Cable Company continues not to accept notices from DBS.

In the assessment of management of DBS, if the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the transition of subscribers between the various suppliers.

As at the date of this report, the Council has granted another license to broadcast a special Jewish heritage channel which is also expected to be transmitted via DBS's broadcasts. At present, the broadcasts of independent licensees are not transmitted via DBS.

5.15 Substantial agreements

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

5.15.1 Agreement for the purchase of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: "ADB") and Eurocom Marketing (1986) Ltd. (hereinafter: "Eurocom"), in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the "**ADB Agreement**"). Under the ADB Agreement, DBS purchased a minimum number of decoders from ADB and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS is to send to Eurocom. DBS also has a warranty for the decoders and support service for them from Eurocom. Repair to the decoders is carried out in accordance with an agreement with it from April 2001, which is automatically renewed unless terminated by one of the parties thereto, and which determines conditions and dates for the provision of maintenance services (and replacement of the decoders, if necessary) by Eurocom. In 2006, DBS purchased decoders from Eurocom in the total sum of approximately NIS 55 million. As at the date of these statements, DBS has ordered more decoders under the ADB agreement. Following allegations by DBS with respect to hardware malfunctions in a considerable proportion of the decoders supplied to it by ADB, DBS is negotiating with ADB in formulating an arrangement which shall extend the supplier's liability term for the decoders for another three years for each malfunction.

In December 2006, a deficit demand was sent to Eurocom by the Customs Department at the Taxation Authority for decoders purchased by DBS from Eurocom Marketing and smart cards that had been imported by Eurocom for DBS in the total sum of NIS 10 million (including the sum of approximately NIS 5 million in VAT which, in the assessment of Eurocom Marketing's legal advisers, there is a reasonable chance that there is no effective debt owed for such). Eurocom is currently objecting to the deficit demand, and DBS has provided the securities required by the Customs Department to insure the taxes in dispute. As at the date of this report, a decision has not yet been made with respect to the objection to the deficit demand.

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 has undertaking to lease at least 8 space segments on the satellite. According to information provided to DBS by Israel Aviation Industries (IAI), the Amos 1 satellite is not expected to stop operations before June 2008, the estimated time of termination of operations is during October 2008. These assessments by IAI are forward-looking information based, to the best of DBS's knowledge, on calculations that IAI has done, in accordance with various technical parameters. However, technical failures and other events might also affect the life-span of the satellite.

DBS also has an option to lease up to 2.5 additional space segments (and in a particular case, an additional half a segment) and a right of first refusal to lease all of the space segments in the satellite's Mediterranean beam, which shall be offered for lease by HLL or IAI. As at the date of publication of this periodic report, DBS has not completed the reduction of its past debt as required under the amendment to the agreement of May 2003.

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

The First Space Agreement regulated mechanisms guaranteeing reserve and backup in the event of satellite faults. *Inter alia*, it was prescribed that the satellite's reserve

transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault contemporaneous with another capacity DBS has priority for the restoration of the capacity that it has leased.

Second Space Agreement

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (hereinafter: the "**Second Space Agreement**"), whereby DBS leases from HLL no fewer than 12 space segments on the two satellites (of which 8 on Amos 1), and during 2005 DBS started to lease two additional segments on the same polarity, so there will be no need to adjust DBS's receiver dishes. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, the earlier of the two. The consideration for the lease determined in the Second Space Agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments leased on the Amos 2 satellite, DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the Second Space Agreement. The Second Space Agreement brings together space segments which are to be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

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

As at the date of this report, DBS leases 7 space segments on the Amos 1 satellite (out of the 8 segments under the First Space Agreement), due to a technical restriction which prevented leasing of the eighth segment for a very long period, which required DBS to implement alternative permanent solutions. DBS held negotiations with Aviation Industries regarding the obligation to lease the eighth segment, and the cost thereof. In fact, as at the date of the report, IAI is not charging DBS for lease of the eighth segment. As at the date of this report, DBS is also leasing 6 space segments on the Amos 2 satellite. The rental in 2006 for the First Space Agreement and the Second Space Agreement amounted to approximately NIS 116 million. For the monetary dispute with HLL see section 5.10.1(b) above.

5.15.3 <u>Information and encryption system development agreement</u>

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "NDS") for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. The provisions of the agreement were applied in January 2006, *mutatis mutandis*, to the advanced (second generation) version of the smart card. DBS pays for NDS's services and products based in principle on the number of converters it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber

services, the granting of usage licenses for these applications and the development of future interactive technological services.

5.15.4 Information systems outsourcing agreement

In March 2004, DBS signed an outsourcing agreement with Ness A. T. Ltd. (hereinafter: "Ness") whereby DBS transferred its information system management and project implementation services (hereinafter: the "Service") to Ness and Ness assumed overall responsibility for the supply to DBS of the Service in an outsourcing format. DBS also transferred to the ownership of Ness certain equipment for which the services are provided and which will be transferred to DBS upon expiry of the agreement. The agreement period (subject to early termination rights conditional upon payment) has been defined as eight years from April 1, 2004 (hereinafter: the "Original Agreement Period"), and at the end of the Original Agreement Period the agreement term will be extended automatically for an additional period of five years (hereinafter: the "Extension Period"), unless one party notifies the other party in writing, at least 12 months before the end of the Original Agreement Period of its desire not to extend the Original Agreement Period. During the Extension Period each party may notify the other party in writing, at least 12 months in advance, of its desire to terminate the agreement. During 2005, the Parties agreed to stop the outsourcing of certain of DBS's information systems and to return them into DBS's management. In January 2007, a further amendment to the agreement was signed between the parties (hereinafter: the "additional agreement"), which is to apply retroactively as of January 2006, under which it was agreed, *inter alia*, that the scope of HR services be reduced, and that payments continue to be made for projects until the end of the original agreement term. Likewise, the contract mechanism was altered so that equipment purchasing and maintenance agreements with suppliers were taken out of the ambit of the agreement, and these will be purchased by DBS. Under the additional amendment, each party may terminate the agreement by prior written notice of 30 days.

Termination of the agreement prior to the end of the original term of the agreement shall involve the payment of a separation fee in accordance with the provisions of the agreement.

5.15.5 Finance agreement with the banks

For a summary of the main points of the agreement, see Section 5.12 above and Note 32 to the Company's financial statements for the year ended December 31, 2006, which are included in this periodic report.

5.15.6 Agreements with DBS shareholders – see Section 2.17.3 above.

5.15.7 Agreements with institutional entities – see Section 5.12.4 above.

5.16 Joint venture agreements

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

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

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

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

5.17 Legal Proceedings

5.17.1 On July 6, 2005, DBS submitted a statement of claim in the District Court at Tel Aviv against Pace Micro Technology Plc., in which DBS requested that the court require the defendant to pay the direct costs that DBS incurred in order to fix defective decoders of a particular model assembled and/or manufactured by the defendant and supplied to DBS in 2000-2001. Under the statement of claim, the decoders suffered from three serial hardware faults which were under the defendant's liability and which caused DBS severe damages, mainly due to the need to repair them and to bear the costs involved in such. The claim is for the sum of approximately NIS 31.4 million, and is based on various causes of action including breach of framework agreement by the defendant, negligence against DBS and breach of the provisions of law, DBS retaining its right to sue for additional damages.

5.17.2 On December 28, 2006, a claim was filed against DBS in the District Court at Haifa by Al-Jazeera Satellite Network, which produces and edits the Al-Jazeera channel that is broadcast in Arabic (hereinafter: the "channel"), and the programs broadcast on that channel (hereinafter: the "programs"). In its claim, the plaintiff alleges that DBS has for several years been broadcasting the channel without a permit from the plaintiff, and that it is thereby in breach of its copyright and performers' rights in the channel and in the programs, and of the intellectual property relating to such, and that it is causing it various forms of damage. The plaintiff is suing for a monetary sum of NIS 3,000,000 (for fee purposes), that an injunction be issued against DBS prohibiting it from broadcasting or making use of the channel, that DBS give the plaintiff accounts of all use made of the channel and that DBS give the plaintiff any copy that infringes the plaintiff's copyright. The parties are negotiating a settlement.

5.17.3 On November 6, 2006, an application was filed with the District Court at Tel Aviv to approve a class action against DBS. The claim and the application stated that DBS had not, as it were, returned the full sums owing to the Applicant and to other subscribers who chose to terminate their contract with it, out of the deposit given by them as security in return for terminal equipment lent to subscribers. The Applicant did not set out the total damage of the members of the group, on the grounds that such data was in the possession of DBS. In her view, the damage caused to her as at the date of filing of the claim is NIS 546.74 and she assesses the cumulative damage of members of the group at more than NIS 16 million.

5.17.4 On January 5, 2005, DBS filed a claim in the Local Court at Tel Aviv against a company and two of its subscribers following information that it had received that the broadcasts of channels 5+ and Tchelet, originally produced by it, were being transmitted on the internal cable network of the town of Efrata in Judea, and were being received in all of the homes of that town that were connected to such cable network. Investigations by DBS showed that the channels' transmissions were being received via two decoders which contained DBS smart cards, and that those decoders were decoders that had been given to the defendants. It also became apparent that transmission of the broadcasts of the channels in the town was being done via the broadcast center operated by the defendants in the town. DBS demanded to charge the defendants to pay compensation in the sum of NIS 2,000,000 for filing fee purposes, and in addition, DBS petitioned for a declaratory order to the effect that the Defendants had breached DBS's rights under the Copyright Ordinance. Since liquidation orders and receivership orders were issued against the two defendants in the file, and in light of information regarding the poor financial situation of the remaining defendant in the file, DBS decided to withdraw the claim. On August 9, 2006, DBS filed a debt claim in the sum of NIS 27,200,000 to the Official Receiver for the debt of one of the defendants.

5.17.5 On July 6, 2005, DBS filed a statement of claim in the District Court at Tel Aviv, in which it requested that the Court charge the defendant to pay the direct costs which DBS bore in order to repair faulty decoders of a certain model assembled and/or manufactured by the defendant and supplied to DBS between 2000-2001. The claim is in the sum of approximately NIS 31.4 million and is based on various causes of action, including breach of framework agreement with the defendant, negligence to DBS and breach of legal provisions, DBS retaining its rights to sue for additional damage.

5.17.6 For other legal proceedings in which DBS is involved, see Notes 15, 17 and 32 to the Company's financial statements for the year ended December 31, 2006, included in this periodic report, and Section 1.1.5(a) above.

5.18 Goals and Business Strategy

5.18.1 DBS's goals are to continue the trend of growth of DBS's revenues, by continuing the gradual increase in the number of DBS's subscribers, DBS intending a relatively small increase compared with the rate of increase in 2005 and 2006, and by continuing the growth of its average revenue per user (ARPU).

5.18.2 In order to achieve the goal of increasing the number of subscribers, DBS intends to invest considerable efforts in the field of marketing and sales and in appropriate marketing strategies, which are intended for the continued recruitment of subscribers, via DBS's sales system, to continue its efforts to create differentiation and innovation in the content of its broadcasts compared with those of the Cable Company, to continue expanding DBS's added value services, and to continue investing in customer services and in retention of existing customers and to increase revenues from them. These efforts include DBS's striving to obtain a license for VOD services, and for the option to market a bundle of services including television services, internet packages and telephony services either by obtaining a license to supply VOB services or by marketing the telephony services of a third party. In addition, DBS is working on increasing penetration of PVR decoders among its subscribers, so as to increase its revenues and the loyalty of its subscribers to its services.

5.18.3 In order to increase ARPU, DBS is working on obtaining a license for VOD services, to market telephony services and to increase the penetration of PVRs as aforesaid, and in addition, is working to increase the scope of content sold to subscribers, by expanding content supply, availability of a variety of services and intensive efforts to sell DBS's products.

5.18.4 DBS's goals with respect to increasing the number of subscribers and the ARPU are based on forecasts by management of DBS, based on the current trend in the broadcast market and on DBS's presumptions regarding competition in the field of broadcasts and regulations, which apply and which shall apply to DBS's operations and the restrictions imposed upon DBS and its operations, taking into account the restrictions applying to and that shall apply to Bezeq, which affect DBS. However, DBS management forecasts might not come to fruition due to changes in demand in the broadcast market, due to increased competition in this field and due to regulatory restrictions imposed or which might be imposed on DBS or on its joint ventures with Bezeq (see section 5.6.5 above). Realization of DBS's goals with respect to the launch of VOD and telephony services depend, in addition to the above, on obtaining the statutory and regulatory consents required for such purpose (see section 5.6.5 above), and for VOD services, on DBS's agreement to provide such under conditions that will enable the service to be provided, from DBS's point of view, on the availability of Bezeq's DSL network and on the ability to provide the service at a quality level for the Company's subscribers (see section 5.6.5F above). Increasing the penetration rates of PVRs depends also on the availability of such decoders and the dates of supply of them by the manufacturer.

5.19 Discussion of Risk Factors

The following are the threats, weaknesses and risk factors of DBS (hereinafter: the "**Risks**") deriving from its general environment, from the industry and from the special nature of its operations. It should be emphasized that the risks set out below are rated according to various levels of reasonableness of occurrence, and the reasonableness of the occurrence of some of them, in DBS's assessment, would be very low. However, each risk has an affect irrespective of the reasonableness of its coming about.

5.19.1 **<u>Macro risks</u>**

5.19.1.1 Financial risks – a substantial part of DBS' expenses and investments are linked to fluctuations in the exchange rate of the US dollar. Therefore, strong fluctuations in the exchange rate will have a substantial effect on the business results of DBS. In addition, loans taken out by DBS from banks, from its shareholders and from institutional entities are partly linked to the consumer price index and therefore sharp rises in inflation might have a substantial affect on DBS's business results; some of the loans taken out by DBS from banks are at variable interest rates and therefore, sharp rises in interest rates might have a substantial affect on the business results of DBS.

5.19.1.2 Recession – an economic recession, increase in unemployment rates and a decrease in disposable income might bring about a decrease in the number of DBS' subscribers, a decrease in DBS' revenues and harm to its business results.

5.19.1.3 Security situation – a continued unstable security situation in most of Israel, which disrupts the day-to-day lives of residents, might bring about a downturn in DBS's business results.

5.19.2 <u>Sector Risks</u>

5.19.2.1 Dependence on licenses – DBS provides multi-channel television broadcasts in accordance with a broadcast license and via other licenses. Breach of the provisions of the licenses are likely to bring about, subject to the conditions set out for such in the licenses, the cancellation amendment or suspension of the licenses and as a result of such, substantial harm to DBS's ability to continue operating in the field, and to imposition of monetary sanctions on DBS.

5.19.2.2 Changes in regulation – DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies, and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of consents from the Council and the Ministry of Communications. A very high level of regulatory intervention and changes in regulation have an effect on DBS' operations and could substantially harm its financial results.

5.19.2.3 Strong competition – the field of broadcasts is characterized by a very high penetration rate and very strong competition, which requires DBS to constantly and continually be investing in recruiting and retaining customers; and dealing with high transfer rates of customers between DBS and the Cable Company. The offer of a bundle of services containing multi-channel television, internet and telephony, which are not offered in this format by DBS, also increases the ability of the Cable Company to compete. Non-provision of VOD services by DBS when the Cable Company does offer such services to its customers also harms DBS's ability to compete.

5.19.2.4 Development of new technology – there is a risk in the development of new technology which will prevail over existing technology and turn the existing technology into old technology, and as a result a need for large monetary investments in order to retain competitive standing or alternatively in the event of development of new technologies that enable entry into the field of multi-channel broadcasts without making heavy financial investments, the entry barriers into the field might be lowered and this will constitute a threat to DBS's competitive status. For IPTV technology see section 5.1.4.2 above.

5.19.2.5 Types of payments and supervision of tariffs – DBS's license provides the kinds of payments that the Company is permitted to collect. In addition, the Council has the power not to allow amendments to the price list. These restrictions affect DBS's ability to manage a commercial price policy.

5.19.2.6 Piracy – DBS is exposed to attempted "piratic" connection by viewers wishing to receive DBS broadcasts without paying a subscription fee. DBS assesses this phenomenon as being marginal only.

5.19.2.7 Exposure to claims regarding broadcast of content that breaches legal provisions – DBS is exposed to claims regarding broadcast of content that breaches legal provisions, including breach of intellectual property rights, damage to privacy, damage to good name, broadcast of prohibited content, etc. Its agreements with content suppliers and program producers usually include an undertaking by the supplier / producer to indemnify DBS in the event of contact that infringes the provisions of the agreement and the law.

5.19.3 <u>Special risks to DBS</u>

5.19.3.1 The need to arrange additional sources of financing for DBS – raising of sources of financing based on DBS's business plan for the coming years, is essential for DBS's ability to comply with its business plan and enable it to pay back its bank

credit on time. Failure to pay this back on time constitutes grounds for making the bank credit immediately repayable in accordance with and subject to the provisions and restrictions of the financing agreement. Note that there is a regulatory restriction on raising funds from the shareholders of DBS.

5.19.3.2 Need for receiving consents from financing banks for the performance of operations by DBS – the doing of operations and certain proceedings are dependent upon the receipt of the prior consent of the banks. This restriction might hinder DBS's operations.

5.19.3.3 Exposure to the provision of immediately repayable bank credit as a result of non-compliance with financing agreements – failure by DBS to comply with the provisions of the financing agreement might, in accordance with and subject to the provisions of the financing agreement, give the banks grounds for making all of the bank credit provided to it immediately repayable and the exercise of the securities provided by DBS and its shareholders to the banks.

5.19.3.4 Restrictions that are the result of the ownership structure – restrictions imposed upon Bezeq restrict it from providing sources of finance to the Company and from cooperating for the purpose of offering a communications service bundle. These restrictions substantially affect DBS's commercial situation and its ability to compete – see section 5.6.5G above.

5.19.3.5 Failure and damage to satellite – DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space. The duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a failure in one of the satellites, it will be possible to move most of the channels broadcast by DBS via the existing space segments on the other satellite, and perhaps even via additional segments on the satellite that might be made available for DBS's use. The Company has no insurance for loss of revenues causes due to satellite malfunction.

5.19.3.6 Dependence on space segment suppliers – DBS depends on HLL and IAI which lease it the space segments. Since both of the satellites are in the same place in space, if one of the suppliers stops leasing space segments to the company, DBS assesses that its business results will not be substantially harmed. The aforesaid is forward-looking information based on the assessments of management of DBS regarding the availability of space segments on the remaining satellite and on exercise of DBS's right for back-up with the supplier. However, failure by the supplier to comply with its undertaking to back up as aforesaid might cause substantial harm to DBS's business results.

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

5.19.3.8 Dependence on use of internal wiring – DBS depends on the use of internal wiring in subscriber homes, which is owned by the Cable Company, and the use of which is effected in accordance with the administrative order. As set out in section 5.14.3 above, as at the date of the financial statements, the Ministry of Communications is considering cancelling the administrative order. If the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the recruitment of subscribers to DBS.

5.19.3.9 Harm to broadcast centers – harm to a broadcast center might cause a significant difficulty for continued broadcasts, however, the splitting of broadcasts into two broadcast centers (Kfar Saba and Reem Junction) significantly reduces the risk involved in harm to one of them and improves the possibility that most of the

broadcasts will survive. As at the date of these reports, DBS broadcasts from both of the broadcast centers at once, some channels being broadcast from one center and DBS's home channels being broadcast only from Kfar Saba, and being stored at the broadcast center at Kfar Saba only. If one of the broadcast centers is damaged, DBS will transmit most of its broadcasts via the second broadcast center, however, as at the date of the reports, in the event of damage to DBS' broadcast center at Kfar Saba, the Company will have only a limited ability to transmit DBS' home channels via the other broadcast center, and DBS is operating to improve the broadcast of home channels from the secondary broadcast center.

5.19.3.10 Technical inferiority and the inability to offer combined services – DBS's technology is technically inferior to that of its competitors. This technical inferiority prevents DBS from providing telephony services, internet and various interactive services, including VOD, over its infrastructure, and requires it to purchase these services or to enter into joint venture agreements in order to provide such services to its customers.

5.19.3.11 Inability to offer a combined analog and digital package – DBS provides its customers with digital decoders only, whilst the Cable Company can provide both analog and digital decoders. The offer of two kinds of decoders makes the cost of equipment cheaper for subscribers, and improves the Cable Company's ability to compete.

5.19.3.12 Defects in the encryption system – DBS's broadcasts are based on the encryption of broadcasts transmitted via satellites and encoded via smart cards that are installed in the decoders in subscribers' homes. Defects in the encryption system or breach of it might enable broadcasts to be viewed without payment being made to DBS, thereby causing a reduction in revenues and a breach of the agreements between DBS and its content suppliers.

5.19.3.13 Exposure due to broadcast of channels without an agreement – DBS broadcasts approximately 10 channels to its subscribers which are broadcast from their broadcast origin as unencrypted satellite broadcasts, and which can be received in Israel (even without a decoder) without any agreement with the owners of the broadcast rights. DBS makes an effort to regulate contracts with owners of broadcasting rights and is exposed to claims by the owners of broadcasting rights.

5.19.3.14 Exposure to payments of stamp duty - DBS might be required to pay stamp duty on agreements which it signed before stamp duty was repealed. DBS has made an appropriate provision in its financial statements.

5.19.3.15 Exposure to class actions – given the large number of subscribers that the Company has, the Company is exposed to class actions and the more subscribers, the greater the exposure to class actions in significant sums. For applications pending against DBS for approval of claims as class actions see section 5.17 above.

5.19.3.16 Compliance with conditions and instructions of the Ministry of the Environment regarding the broadcast center – in the event of failure to comply with the conditions and instructions of the Ministry of the Environment with respect to the broadcast center.

5.19.4 The following table sets out the risk factors based on their nature and ranking according their effect in the opinion of DBS's board of management.

Level of Effect			
Small	**Medium**	**Large**	
			Macro risk
	X		Financial risks
X			Security situation
X			Recession
			Industry Risk
	X		Dependence on licenses
		X	Changes in regulation
		X	Strong competition
		X	Development of new technology
X			Tariff control
X			Piracy
X			Exposure to claims for broadcasting infringing content
			Special Risk
		X	Need to arrange additional sources of finance
X			Need for approval for company operations from financing banks
	X		Exposure to bank credit becoming immediately repayable due to non compliance with financing agreements
		X	Restrictions due to structure of ownership
	X		Satellite malfunction
	X		Dependence upon space segment supplier
		X	Dependence on suppliers of content, equipment and infrastructure
	X		Dependence on suppliers of essential content
		X	Damage to broadcast centers
		X	Technical inferiority and inability to offer combined services
X			Inability to offer combined analog and digital packages
		X	Encryption system
X			Exposure regarding broadcast of channels without agreement
X			Stamp duty
	X		Legal proceedings
X			Compliance with environmental restrictions

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:
Dov Weisglass, Chairman of the Board
Yacov Gelbard, CEO

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

Chapter B of the Periodic Report
Directors' Report on the State of the Company's Affairs
<u>for the year ended December 31, 2006</u>

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies together are hereinafter referred to as "the Group") for the year ended December 31, 2006 (hereinafter: "the Directors' Report").

The Group operates in four areas which are reported as business segments in the Company's consolidated reports as set forth below:

1) **Fixed-line domestic communications**

2) **Cellular**

3) **International communications and internet services**

4) **Multi-channel television**

The Company has other areas of activity which are not material to the Group's operations, and these are included in the financial statements as at December 31, 2006 of the Company in the "Other" business segment, consisting mainly of network end Point services and customer service centre services.

The Group reports for the first time, in the 2006 financial statements, financial statements prepared in accordance with the International Financial Reporting Standards (IFRS), this being subsequent to a comprehensive discussion by the Board of Directors and resolution to approve Management's recommendation to adopt the IFRS in 2006, even though the regulations require adoption only from January 2008. As a result thereof the 2005 financial statements, which were prepared in the past in accordance with generally accepted accounting principles in Israel, were presented in accordance with IFRS. The effect of the transition to reporting in accordance with international standards on the financial position of the Company and on the results of its operations and its cash flows, is described in Note 33 to the financial statements. In order to properly reflect the financial position of the Company according to Israeli GAAP before the transition to IFRS, the financial statements of the Group were adjusted by way of restatement, as explained in Note 33(u) to the financial statements.

1. Financial Position

A. The Group's assets as at December 31, 2006, amounted to approximately NIS 17.54 billion, compared with NIS 19.39 billion on December 31, 2005. Of these, approximately NIS 6.49 billion (approximately 37%) are property, plant and equipment compared with approximately NIS 7.25 billion (approximately 37%) on December 31, 2005.

Most of the decrease stems from the fixed-line domestic communications segment. In this segment there was a decrease in total assets compared with the previous year of approximately NIS 780 thousand, mainly resulting from the realisation of financial assets held for trading which was moderated by an increase in the cash balances. In addition, there was a decrease in the depreciated cost of property, plant and equipment resulting from the difference between depreciation expenses and the investment made in the reporting period.

In the cellular segment, assets decreased from approximately NIS 4.72 billion as at December 31, 2005 to approximately NIS 3.97 billion as at December 31, 2006. Most of the decrease arose from the realisation of financial assets held for trading which were used for distribution of a dividend and repayment of loans and from a decline in the depreciated cost of the property, plant and equipment. Additionally, there was a reduction in the deferred tax balances due to the utilization of past losses for tax purposes.

In the international communications and internet services segment, there was a decrease in total assets compared with December 31, 2005, mainly due to an decline in cash balances. The reduction is mainly in respect of repayment of loans to the Company and distribution of a dividend, which will be offset by a positive cash flow from ongoing activities.

In the multi-channel television segment, there was a reduction in total assets compared with December 31, 2005, which derived primarily from a reduction in the net investment balance in property, plant and equipment.

B. The shareholders' equity of the Company at December 31, 2006, amounted to approximately NIS 5.76 billion, comprising approximately 33% of the total balance sheet, compared with approximately NIS 6.56 billion on December 31, 2005, which comprised approximately 34% of the total balance sheet. The decrease in shareholder' equity derives from dividends paid and declared in the reporting period amounting to NIS 1.9 billion. The decrease was moderated by the Group's net earnings. Subsequent to the date of the reports, an additional dividend of NIS 1.8 billion was distributed in February 2007 (see Note 20 to the financial statements).

C. Total Group debt at December 31, 2006 amounted to approximately NIS 8.02 billion, compared with approximately NIS 9.41 billion on December 31, 2005. The Group's debt to financial institutions and debenture holders as at December 31, 2006, amounted to approximately NIS 7.46 billion, compared with approximately NIS 8.91 billion on December 31, 2005. The decrease is primarily attributable to a reduction in liabilities in the cellular segment and the fixed-line domestic communications segment. The reduction was partly offset by a rise in liabilities in the multi-channel television segment.

The Company's auditors have drawn attention to the financial position of DBS, as appears in Note 32(3) to the financial statements, including an assessment from DBS's management based on the budget for 2007 and an alternative business plan according to which there is a good chance of arranging the financial sources which will be required for the coming year.

D. Group cash balances as at December 31, 2006, amounted to approximately NIS 3.59 billion, compared with approximately NIS 4.56 billion on December 31, 2005. The decrease is primarily attributable to the realisation of securities held for trading in the cellular segment and in the fixed-line domestic communications segment, which were realized for payment of a dividend of NIS 1.6 billion in the reporting year and for the repayment of liabilities. The decrease was partially offset by cash flow from current operations in the principal segments of the Group's operations.

2. Results of Operations

A. Principal results

Net earnings attributable to the shareholders of the Company for 2006 amounted to approximately NIS 809 million, compared with net earnings of approximately NIS 666 million in the corresponding year. The rise in the net earnings is primarily attributable to an increase in operating income and a decrease in the costs of financing, which were offset by a gain from the sale of an operation recorded in 2005. Earnings after financing expenses amounted to approx NIS 1,227 million compared with NIS 1,052 million in the corresponding year.

Below are details of the changes in the results of the segments compared to the corresponding year.

Segment	2006 NIS millions	2005 NIS millions
Fixed-line domestic communications	746	919
Cellular	692	585
International communications and internet services	131	100
Multi-channel television	8	(78)
Others	(12)	1

Net earnings per share for 2006 amounted to NIS 0.311 per NIS 1 par value, compared with earnings of NIS 0.256 per share in the corresponding year.

B. Revenues

Group revenues in 2006 amounted to approximately NIS 12.23 billion compared with earnings of approximately NIS 11.92 billion in the corresponding year.

Revenues from fixed-line domestic communications decreased from approximately NIS 5.89 billion in 2005 to approximately NIS 5.80 billion in the year reported (a decrease of approximately 1.6%). Most of the decrease in the segment's revenues is attributable to tariff reductions in June 2005 and July 2006 and a decrease in call traffic. The decrease in revenues was moderated primarily by ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). The Company's auditors drew attention to the continuing opening of the communications sector to competition and the effects of regulation..

Revenues from the cellular telephone segment increased from approximately NIS 4.43 billion in 2005 to approximately NIS 4.48 billion in the year reported. The growth derived from the increase in revenues from cellular services caused by an increase in content revenues, in average per-subscriber use and in the number of customers. In contrast, there was a decrease in revenues from the sale of terminal equipment resulting from a decline in the number of handsets sold and upgraded and from sales campaigns in 2006.

Revenues from the international communications and internet services segment increased from approximately NIS 847 million in 2005 to approximately NIS 1,038 million in the reporting period. The increase is attributable to a growth in revenues in all sectors and an increase in global activity. In addition, there was an increase in internet revenues deriving from an increase in the number of high-speed internet customers, sale of capacity and growth of integration.

Revenues in the multi-channel television segment increased from approximately NIS 1,221 million in 2005 to approximately NIS 1,362 million in the reporting period, resulting from an increase in the number of subscribers and an increase in the average revenue per customer.

C. **Depreciation and amortisation**

The Group's depreciation and amortisation expenses decreased from approximately NIS 1,934 million in 2005, to approximately NIS 1,864 million in the year reported, resulting from a decrease in the depreciation expense due to property plant and equipment being fully depreciated and a decrease in investments in new property in the fixed-line domestic communications and the international communications and internet services segments. The decrease was offset by an increase in depreciation expenses in the cellular segment due to the accelerated amortization of sites designated for dismantling and due to an increase in the multi-channel segment.

D. **Salaries**

The Group's salary expenses in 2006 amounted to approximately NIS 2,586 billion, unchanged as compared to the corresponding year.

In the fixed-line domestic communications segment, salary expenses decreased as a result of the retirement of employees, and a decrease in the value of stock options allocated by the State to Company employees in 2005 compared with the value of the options allocated to employees by the Company in 2006. This decrease was offset by salary increases. In addition, salary expenses decreased in the cellular segment and increased in the international communications and internet services and multi-channel television segments.

E. **Operating and general expenses**

The Group's operating and general expenses in 2006 amounted to approximately NIS 5.97 billion, unchanged as compared to the corresponding year.

In the fixed-line domestic communications segment, operating and general expenses decreased from approximately NIS 2,391 million in 2005 to approximately NIS 2,233 in the year reported. The decrease derived from a reduction in royalties expenses due to a 0.5% reduction in the royalties rate from January 1, 2006 (see Note 29B to the financial statements), a reduction in the provision for royalties in the fixed-line domestic communications segment resulting from an agreement with the Ministry of Communications to end past disputes up to and including 2002 (see Note 29B to the financial statements), and a deduction for interconnect (see Note 29C). In addition, there was a decline in materials and spare parts, subcontractor services and maintenance, cellular telephone and building maintenance.

In the cellular segment, general and operating expenses decreased from approximately NIS 2,813 million in 2005 to approximately NIS 2,741 million in the year reported, resulting from a reduction in the costs of terminal equipment alongside a decrease in revenues from the sale of terminal equipment, in addition to a decrease in the costs of spare parts and laboratory repairs

and a decrease in salary expenses and doubtful debts. The decrease was partly offset by an increase in site maintenance and an increase in call termination charges, expenses for content operations and advertising expenses.

In the international communications and internet services segment there was an increase in general and operating expenses from approximately NIS 485 million in 2005 to approximately NIS 641 million in the year reported. The increase is primarily due to growth in global operations in parallel with growth in revenues, and a growth in expenses related to internet customers and customer recruitment expenses.

In the multi-channel television segment, general and operating expenses increased from approximately NIS 843 million in 2005 to approximately NIS 889 million in the year reported, resulting from an increase in content expenses and leasing fees for satellite segments.

F. **Other operating expenses (income), net**

Other operating expenses, net, for the Group totalled approximately NIS 250 million in 2006, compared with Other operating expenses, net, totalling approximately NIS 100 million in the corresponding year.

The expenses in 2006 derived mainly from the fixed-line domestic communications segment, which recorded a provision of approximately NIS 309 million in respect of employer-employee relations upon retirement, due to the new collective agreement and the change in the organizational structure of the Company. The provision recorded in respect of the same item in 2005 amounted to approximately NIS 83 million, due to an arrangement with an alternative insurance entity for Makefet Fund for regulating the terms of early retirement of employees.

In addition, net capital gains stemming primarily from the realization of real estate assets of approximately NIS 159 million, were offset by provisions in respect of contingent claims.

G. **Operating income**

The Group's operating income in 2006 amounted to approximately NIS 1,565 million, compared with approximately NIS 1,527 million in the corresponding year, a decrease of approximately NIS 38 million. The decrease in operating income is attributable to the changes in the results of the segments described above in the revenue and expense items. These changes led to a decrease in the profitability of the fixed-line domestic communications segment, an increase in the cellular telephone segment and international communications and internet services segment, and an improvement in the results of operations in the multi-channel television segment.

H. **Financing expenses**

The Group's net financing expenses in 2006 amounted to approximately NIS 338 million, compared with approximately NIS 371 million in the corresponding year, a decrease of approximately NIS 33 million. The decrease is due to a reduction in financing expenses in the cellular segment deriving from erosion of CPI-linked loans and a reduction in the number of loans in the segment.

Financing expenses also decreased in the fixed-line domestic communications segment as compared with the corresponding year, mainly as a result of an increase in income from the capital market, cancellation of the provision in connection with an agreement with the Ministry of Communications to terminate past disputes (see Note 29B to the financial statements), and income from a venture capital fund in which the Company invested..

J. **Quarterly data – Consolidated statements (in NIS millions)**

The financial statements for quarters 1-3 were prepared again in order to comply with the International Financial Reporting Standards (IFRS)

	2006	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenue	12,232	3,116	3,082	3,019	3,015
Costs and expenses	10,667	3,187	2,532	2,444	2,504
Operating income	1,565	(71)	550	575	511
Financing costs	338	29	92	146	71
Earnings before Group's equity in earnings of associates	1,227	(100)	458	429	440
Equity in earnings of associates	11	7	2	1	1
Earnings before income tax	1,238	(93)	460	430	441
Income tax	488	21	187	143	137
Earnings for the year	750	(114)	273	287	304
Earnings attributable to the shareholders of the Company	809	(108)	290	308	319
Minority interest in a consolidated company	(59)	(6)	(17)	(21)	(15)
Total earnings recognised in the period	750	(114)	273	287	304

The fourth quarter ended with an operating loss, mainly due to provision of NIS 309 in respect of an early retirement plan (see Note 16G to the financial statements), and due to share-based payments of NIS 287 million to employees (see Note 26 to the financial statements).

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2006 amounted to approximately NIS 3,709 million, compared with approximately NIS 3,162 million in the corresponding year, an increase of approximately NIS 547 million. The increase in cash flows generated by operating activities is primarily attributable to an increase in operating income, to revenues and expenses not involving cash flows, and changes in the assets and liabilities items. Most of these changes were in the cellular segment.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the year reported included approximately NIS 953 million invested in development of communications infrastructures, compared with investments amounting to approximately NIS 1,477 million in the corresponding year. During 2006, the Group realised investments in net financial assets of approximately NIS 1,534 million – mainly negotiable securities, compared with net investments of approximately NIS 827 million in the corresponding year.

In the year reported, the Group repaid debts and paid interest of approximately NIS 2,151 million, of which approximately NIS 1,269 million was on account of long-term loans, and NIS 280 million of debentures and NIS 602 million in interest payments. The Group raised new debt in the year reported, amounting to approximately NIS 93 million, totalling net debt repayment of approximately NIS 2,058 million. This compares with the net debt raised amounting to approximately NIS 53 million in the corresponding year. In the year reported, a dividend totalling NIS 1,600 million was distributed (see Note 20 to the financial statements).

The average monthly short-term borrowing from banks in 2006 was approximately NIS 128 million. The average monthly long-term liabilities in 2006 were approximately NIS 7,950 million.

Working capital at December 31, 2006 is negative and amounted to approximately NIS 1,169 million, compared with positive working capital of approximately NIS 617 million on December 31, 2005. The decrease is due to the fixed-line domestic communications segment, resulting from an increase in current maturities of debentures, an obligation to pay a dividend declared, and realization of monetary assets held for trading. The decrease was moderated to some extent by an increase in the working capital of the other principal Group companies.

4. The considerations of the Board of Directors in deciding on or recommending grant of payments to each of the five highest salary recipients of its officers

The salary of the five highest-salaried officers was approved by the Board of Directors in accordance with the recommendation of the CEO (except regarding the CEO himself and the Chairman of the Board whose salary was approved by the Audit Committee, the Board of Directors and the general meeting of the shareholders). The salary levels of the officers are comparable to those at similar corporations in the country.

5. Group involvement in the community and donations

The Group is active in the community through its involvement in social institutions and organizations such as the education system in underprivileged areas and the confrontation line, and its contributions during the year reported amounted to approximately NIS 2.6 million. In addition, Group employees volunteer in additional and diverse community involvement activities. For example, in the academic year, some 500 Group employees gave workshops to junior high school students on “Exposure to Modern Communications”, in cooperation with the Ministry of Education.

During the period of the fighting in the north the Group’s companies embarked on various activities for residents of the north which included, *inter alia* ,the connection of televisions to the internet and satellite television, free calls, renovation of shelters and their equipment and the provision of service under fire to citizens and soldiers. In addition, the employees donated and distributed food products, games and gift packages for the residents.

During the reporting period the Company donated approximately NIS 1.5 million to institutions and organizations in the community the principal subjects of which are listed below:

In the project “Children and Parents Study Computer and Internet”, which has been ongoing for some five years, the Company's employees voluntarily mentor underprivileged parents and children on selected subjects in the field of computers and the internet. The cost of the project, in addition to the hours volunteered by the employees, amounts to some NIS 250,000 per year.

In the “Summer for the Community” project, which the Company has initiated for the past three years, children of employees worked in medical institutions and community centres during the summer. The cost of the project to the Company was approximately NIS 1 million.

In the last quarter of the year the “Milk, Bread and Eggs” not-for-profit association, which was established by Company employees and pensioners, began functioning. The association works in cooperation with the local authorities to locate disadvantaged families in order to supply them with basic food products.

Pelephone has no binding policy regarding donations and its management discusses each case on an individual basis. During the reporting period, Pelephone donated some NIS 229 thousand to various associations.

Bezeq International is involved in ongoing operations on behalf of underprivileged communities in Petach Tikva, it adopted “lone” soldiers, adopted a fighting division and participated in projects for special needs children. During the reporting period, Bezeq International's expenses amounted to approximately NIS 900,000.

6. Details concerning market risks exposure management

Responsibility for management of the Company’s market risks

The person responsible for management of the Company's market risks is the Deputy CEO and CFO, Ran Oz. For details of his education and experience, see Section 13(D) in Chapter D of the Periodic Report.

Description of market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment and the prices of securities.

Most of the Company's debentures are linked to the consumer price index and those which are eurobonds or denominated in euro, bear fixed interest, and therefore a change in the interest rate will affect their fair value and not their carrying value.

In addition, the Company has euro-linked debentures bearing variable interest and exposed to changes in the eurobond rate.

The Company has investments in negotiable bonds that are shown in the Company's books at their market value. This market value is influenced by changes in the interest rates in the economy.

At the date of this report, the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that it will do so under future market circumstances. Furthermore, the Company takes into account such influences when considering the types of loans it takes and when managing its investment portfolio.

Exchange rates – Changes in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future earnings and cash flows, mainly the repayment of currency-linked liabilities and payments for the currency-linked purchase of equipment and raw materials.

In order to minimize this exposure, the Board of Directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed an amount equivalent to $150 million, of which not more than the equivalent of $50 million would relate to currencies other than the U.S. dollar. In addition, the Company is able to implement additional hedging transactions from time to time against exposure related to expected transactions during one year of operation, this being limited to a total volume not exceeding the equivalent of $100 million – of which not more than the equivalent of $30 million would relate to currencies other than the U.S. dollar. The reduction of exposure during the reporting period was accomplished by purchase (or sale, depending on the direction of the exposure) of forward transactions in currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward transactions is equal to or shorter than the time frame of the hedged exposure.

The Company recorded no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing expenses of approximately NIS 46 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year.

The Company's tariff updating mechanism as set forth in the Regulations allows tariffs to be updated according to the rise in the CPI (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs and on its revenues. On the other hand, the influence of the rate of inflation on the Company's expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms.

In addition, the Company invests a considerable part of its cash balances in unlinked shekel value deposits, and these deposits are exposed to changes in their real yield caused by a change in the rate of inflation.

The low rate of inflation prevailing in Israel in recent years has considerably reduced the financial significance of this risk.

The Company has a surplus of liabilities over CPI-linked assets. As part of its policy of minimizing exposure, the Company has made hedging transactions against the CPI so as to reduce this risk.

Prices of raw materials and equipment – Cash flows generated by the Company's operations are used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral price indices, exchange rates and global prices. The Company does not hedge against this exposure.

Prices of securities – The Company invests some of its financial balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors set investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments, while the share component will not exceed 15% of the investment portfolio and will include shares invested in the TASE 100. The types of bonds and their proportional part in the portfolio were determined according to criteria based on linkage, redemption date and separation between government and non-government bonds. Additionally, a monetary ceiling was determined for the various types of investments.

Supervision and implementation of market risk management policy – As part of the financial management policy at the Group level, a "Finance Team" was appointed and meets once a month, *inter alia*, to make recommendations on market risk policy and management to the boards of directors

of the Company and its subsidiaries. These recommendations and regular updates on exposure to market risks are then discussed by those boards of directors from time to time, as necessary. Exposure reports are presented to the Board of Directors of the Company once every quarter.

Description of the risks and their management in the subsidiaries – The persons responsible for management of the market risks in the principal consolidated companies are the Chief Financial Officers of those companies and at Pelephone – the Treasurer of the company. The subsidiaries enter into hedging transactions in accordance with the decisions of their boards of directors and under their supervision.

The financial statements include financing expenses of approximately NIS 64 million from hedging transactions entered into during the year reported..

Linkage based report

Information on the linkage terms of the monetary balances of the Company and the Group at December 31, 2006, follows;

	In unlinked NIS	In CPI-linked NIS	In or linked to the dollar	In or linked to euro	Total monetary balances
	NIS Thousands	NIS Thousands	NIS Thousands	NIS Thousands	
Assets					
Cash and cash equivalents	2,578,740		48,244	4,806	2,631,790
Trade receivables	2,036,496	12,181	55,353	7,421	2,111,451
Other receivables	152,310	4,370			156,680
Other investments, including derivatives	328,876	489,712	123,454	29,624	971,666
Trade receivables and other long-term receivables	387,909	24,484	4,751		417,144
Long-term investments and loans, including derivatives	259,965	36,633	7,821	38,627	343,046
Total assets	5,744,296	567,380	239,623	80,478	6,631,777
Liabilities					
Loans and borrowings	765,928	1,242,008		1,629,411	3,637,347
Trade payables	992,158		380,967	20,443	1,393,568
Dividend proposed	300,000				300,000
Other liabilities and current provisions	825,277	283,950	2,542	74,800	1,186,569
Debentures		3,147,436		30,380	3,177,816
Long-term liabilities to banks		480,830			480,830
Loans provided by a minority and others		733,432			733,432
Employee benefits	1,279,239				1,279,239
Other long-term liabilities and provisions	51,857	19,176			71,033
Total liabilities	4,214,459	5,906,832	383,509	1,755,034	12,259,834

Positions in derivatives at December 31, 2006 (consolidated)

(amounts following are in NIS thousands)

Dollar / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - not recognized for accounting	380,013	104,358	-	-	(6,596)	16	-	-

Euro / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging – not recognized for accounting	1,574,435	-	-	-	(30,967)	-	-	-

CPI / NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - not recognized for accounting	50,000	-	300,000	-	(5,755)	-	(7,920)	-

Sensitivity analysis

Sensitivity to changes in the dollar/NIS rate of exchange

	Gain (loss) from the changes		**Fair value**	**Gain (loss) from the changes**	
	10%	5%	–	-5%	-10%
Hedging instruments not recognized for accounting			–		
Dollar/shekel forward transactions	23,065	11,540	(6,580)	(11,540)	(23,109)
Cash	4,824	2,412	48,244	(2,412)	(4,824)
Trade receivables	5,535	2,768	55,353	(2,768)	(5,535)
Other investments	13,596	6,798	135,959	(6,798)	(13,596)
Suppliers and service providers	(38,097)	(19,048)	(380,967)	19,048	38,097
Firm commitments – rent contracts	(5,952)	(2,976)	(803)	2,976	5,952
Firm commitments – space segments	(41,717)	(20,859)	(417,172)	20,859	41,717
Guarantees	(9,295)	(4,648)	(92,950)	4,648	9,295
Total	**(48,041)**	**(24,013)**	**(658,916)**	**24,013**	**47,997**

The table shows the items sensitive to changes in the dollar/shekel exchange rate. The sensitivity of the items in the balance sheet was tested, as were off-balance-sheet items. The firm commitments are off-balance-sheet commitments, denominated and/or linked to the dollar and therefore sensitive to changes in the exchange rate.

Sensitivity to changes in the euro/NIS exchange rate

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	10%	5%		-5%	-10%
Cash	481	240	4,806	(240)	(481)
Trade receivables	742	371	7,421	(371)	(742)
Other investments	2,671	1,335	26,708	(1,335)	(2,671)
Deposit investments	3,863	1,931	38,627	(1,931)	(3,863)
Hedging instruments not recognized for accounting					
Euro/shekel forward transactions	157,452	78,545	(30,967)	(78,713)	(157,480)
Eurobonds	(169,148)	(84,574)	(1,691,478)	84,574	169,148
Debentures	(3,257)	(1,628)	(32,567)	1,628	3,257
Trade payables	(2,044)	(1,022	(20,443)	1,022	2,044
Current liabilities	(4,270)	(2,135)	(42,697)	2,135	4,270
Total	**(12,658)**	**(6,510)**	**(1,732,070)**	**6,342**	**12,631**

The table shows the items sensitive to changes in the euro/shekel exchange rate. The Company has forward transactions for the purchase of euro against shekels for up to seven months. These transactions serve as hedges against the euro-denominated-linked debt.

Sensitivity to change in the consumer price index

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	10%	5%		-5%	-10%
Trade receivables	24	12	12,181	(12)	(24)
Receivables and debit balances	9	4	4,370	(4)	(9)
Other investments	979	489	489,712	(489)	(979)
Debit balances	122	61	61,117	(61)	(122)
Hedging instruments not recognized for accounting					
CPI/shekel forward transactions	2,680	1,340	(13,675)	(1,340)	(2,680)
Other liabilities and provisions	(571)	(286)	(285,705)	286	571
Non-negotiable debentures	(3,658)	(1,829)	(1,828,986)	1,829	3,658
Debentures Series 4	(2,558)	(1,279)	(1,278,840)	1,279	2,558
Debentures Series 5	(966)	(483)	(482,892)	483	966
Bank loans	(2,631)	(1,316)	(1,315,722)	1,316	2,631
Loans from others	(270)	(135)	(134,939)	135	270
Loans provided by minority	(1,129)	(564)	(564,250)	564	1,129
Total	**5,874**	**60**	**(5,339,655)**	**(11,569)**	**(17,383)**

A sensitivity test of 5% and 10% (up and down) was conducted on an inflation assessment of 2% per year, based on the Inflation Target Centre at the Bank of Israel.
The Group has debentures and loans from banks and other sources, which are linked to the CPI.

Sensitivity to changes in real shekel interest rates

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	10%	5%		-5%	-10%
Non-negotiable debentures	(18,814)	(9,472)	(1,828,986)	9,606	19,348
Bank loans	(3,549)	(1,814)	(1,315,722)	1,760	3,601
Loans from others	7,463	3,551	(134,939)	(4,729)	(9,112)
Total	**(14,900)**	**(7,735)**	**(3,279,647)**	**6,637**	**13,837**

The companies of the Group have non-negotiable debt and CPI-linked bank loans to institutional entities. The table tests the debt for changes in the real interest rate.

Sensitivity to change in shekel interest rate

Company	12%	10%	5%	Fair value	-5%	-10%	-12%
Dollar/shekel forward transactions	596	505	248	(6,580)	(246)	(474)	(589)
Euro/shekel forward transactions	4,090	3,355	1,658	(30,967)	(1,780)	(3,497)	(4,213)
Long-term trade receivable debts	(7,191)	(6,009)	(3,018)	793,862	3,046	6,120	7,357
Total	(2,505)	(2,148)	(1,112)	756,315	1,020	2,149	2,555

The sensitivity analysis of the shekel interest rate includes another scenario (12% up and 12% down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 12% in December 2001).

Sensitivity to change in dollar interest rates

Company	15%	10%	5%	Fair value	-5%	-10%	-15%
Dollar/shekel forward transactions	(788)	(532)	(199)	(6,580)	268	538	805

The sensitivity analysis of the dollar interest rate includes another scenario (15% up and 15% down), which examines the most extreme daily change that occurred in recent years (a daily change of 15% in June 2003).
Calculation of the fair value of the forward transactions was by discounting the difference between the price set on the date of measurement for forward transactions for the same future date, and the price in the transaction signed by the Company, multiplied by the nominal value of the transaction and discounted from the date of clearing the transaction to the measurement date.
The interest rates used for calculation of the fair value are risk-free rates for the relevant period (shekel interest and dollar interest).

Sensitivity to change in euro interest rates

Company	10%	5%	Fair value	-5%	-10%
Euro/shekel forward transactions	(2,869)	(1,484)	(30,967)	1,323	2,775

Analysis of sensitivity to changes in the securities rates

	Gain (loss) from the changes			Fair value	Gain (loss) from the changes		
	12%	10%	5%		-5%	-10%	-12%
Shares	4,372	3,644	1,822	36,436	(1,822)	(3,644)	(4,372)

	Gain (loss) from the changes			Fair value	Gain (loss) from the changes	
	118%	10%	5%		-5%	-10%
Share	9,229	782	391	7,821	(391)	(782)

The sensitivity analysis of the share portfolio includes another scenario (12% up and 12% down), in order to examine an extreme situation (a daily change at that level would result in suspension of trading in the security).

Analysis of sensitivity to changes in securities rates

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	2%	1%		-1%	-2%
CPI-linked debentures	47,868	23,934	478,679	(23,934)	(47,868)
Foreign currency line	8,972	4,486	89,719	(4,486)	(8,972)
Debentures series 4	(127,884)	(63,942)	(1,278,840)	63,942	127,884
Debentures series 5	(48,289)	(24,145)	(482,892)	24,145	48,289
Total	**(119,333)**	**(59,667)**	**(1,193,334)**	**59,667**	**119,333**

The sensitivity analysis of the debentures was made at values of 1% and 2%, based on a historical examination of the maximum change in the prices of CPI-linked and foreign currency-linked debentures.

	Gain (loss) from the changes		Fair value	Gain (loss) from the changes	
	2.50%	1.25%		-1.25%	-2.50%
Unlinked shekel debentures	7,225	3,612	288,989	(3,612)	(7,225)

The sensitivity analysis of the shekel (unlinked) debentures was made at values of 1.25% and 2.5%, based on a historical examination of the maximum change in the prices of shekel debentures.
The interest rates used for calculation of the fair value are risk-free rates for the relevant period (shekel interest, euro interest and dollar interest).

Calculation of the fair value of the forward transactions was by discounting the difference between the price set on the date of measurement for forward transactions for the same future date, and the price in the transaction signed by the Company, multiplied by the nominal value of the transaction and discounted from the date of clearing the transaction to the measuring date.

The exchange rates taken for the sensitivity analyses are the representative rates on December 29, 2006:
Dollar/shekel exchange rate – 4.2250.
Euro/shekel exchange rate – 5.5643.

7. Directors with accounting and financial expertise

A. The Company's Board of Directors determined that the minimum number of directors who have accounting and financial expertise, as required by the provisions of the Companies Law, is one (and together with the outside directors – two). The Board of Directors believes that this number will enable it to fulfill the duties imposed upon it by law and by the articles of association, including review of the financial condition of the Company and preparing and approving the financial statements, taking into consideration the size and complexity of its operations.

B. Directors serving in the Company who have the above skills are Zehavit Cohen, Menachem Inbar, Adam Chesnoff and David Blumberg (an external director). For information about their relevant education and experience, see Sections 12(f), 12(g), 12(h) and 12(i) in Chapter D of the Periodic Report. Yigal Cohen-Orgad, a former external director whose term of office ended on January 25, 2007, has the aforementioned expertise.

8. Disclosure concerning an internal auditor in a reporting corporation

(1) **The Company's Internal Auditor**

a) Name: Malka Dror

b) Date of commencement of office: August 14, 2006 (appointed as substitute)

c) The Internal Auditor complies with the conditions set forth in Article 3(A) of the Internal Audit Law. Qualifications: BA in Economics (Hebrew University); CISA (Certified Information Systems Auditor – USA);

Internal auditing experience: 22 years in various internal auditing positions.

d) The Internal Auditor complies with the provisions of Article 8 of the Internal Audit Law and Article 146(B) of the Companies Law.

e) The auditor was granted 44,287options to purchase Company shares held by the State as part of an option outline for Company employees for 2005 on November 15, 2005, within the framework of the State's obligations in connection with the Company's privatization process, and 32,856 options of the Company to purchase its shares as part of the option outline for Company employees on February 22, 2007, in accordance with the Company's obligation under the collective agreement from December 5, 2006.

f) The Internal Auditor has no material business connections or other material connections with the Corporation or with a body affiliated to it.

g. Employment basis: The Internal Auditor is a Company employee.

(2) At its meeting on August 14, 2006, the Board of Directors approved the appointment of Malka Dror who served as manager of the Audit Department in the Company's Audit Unit, as acting internal auditor following a recommendation from the Audit Committee based on her professional qualifications and experience.

(3) The authority and responsibility of the Company's internal auditor are determined in the procedure "The Internal Auditor of the Company". The procedure was revised and approved by the Board's Audit Committee on January 4, 2006.

Duties of the internal auditor according to the procedure

a. To examine whether the activities of the Company, its officers and senior employees are proper from the perspective of upholding the law and proper business management.

b. To examine that the Company's operations were carried out lawfully, by a qualified person, while adhering to principles of efficiency, thrift and purity of ethics, and to ensure that they contribute to the achievement of the goals defined.

c. To indicate deficiencies in the management of the business of the Company.

d. To examine the authenticity and quality of the financial and management information.

e. To inspect the cash management, the Company's liabilities and arrangements to safeguard the Company's assets and their entirety, and their operative efficiency and use.

f. To check whether the Company's decisions, including at the Board and its committee levels, were made in accordance with proper procedures.

g. To inspect the Company's information systems and information security system – in the computer environment and in the computer systems.

h. To examine the correctness of the Company's transactions with its senior managers, with their families or with corporations under their control.

i. To examine the correctness and effectiveness of the Company's procedures for entering into commitments.

j. To investigate complaints made by Company employees and complaints from the public regarding damage to purity of ethics and proper procedures.

k. To recommend that the Audit Committee determine or amend procedures on significant topics.

l. To expose deficiencies, identify the reasons for their existence, and note the causes responsible for them.

m. To make proposals for correcting the deficiencies and preventing their recurrence.

n. To re-audit in order to follow up implementation of the recommendations in the various departments.

The internal auditor's authorities in the Company in accordance with the procedure

a. The Company's internal auditor may demand and receive any information, explanation and document required at her discretion for the performance of her duty, and every

Company employee is obliged to provide any document or information at the Company's internal auditor's first request. Every Company employee requested to provide information to the auditor is required to comply with the request at the time and in the manner determined thereof.

b. The internal auditor is authorized to perform an audit at any time, with a scope that he deems appropriate, in any of the Company's departments.

c. The manager and employees of the audited department will allow the internal auditor and her staff to perform the audit and will assist them with any request.

d. For performance of her duty, the internal auditor shall be granted access to any ordinary or computer databank, to any database and to any automated or non-automated data processing work program in the Company.

e. The internal auditor may enter and inspect any of the Company's assets.

f. The above authorities are also granted to audit department staff and to any person acting on behalf of the internal auditor.

(4) The former internal auditor, Danny Friedman, tendered his resignation after being offered a position in another company. He ended his term of office on August 14, 2006.

(5) **Organizational officer responsible for the internal auditor**

According to a resolution of the Company's Board of Directors, the Chairman of the Board is the organizational officer responsible for the internal auditor.

(6) **Work program**

The work program is annual.

The guiding principle behind the annual work program for the internal audit is the risk inherent in the Company's processes and operations. In order to assess the risks, the audit prepares a ‘control risk survey’ of the Company every year. As part of this survey, the audit examines, in cooperation with the Company's senior management, the material exposures and risks in the Company's operations and the control environment existing for the management of these risks. The survey’s findings are used to compile the topics for the annual and multi-year work program.

The considerations taken into account in the compilation of the work program are these: reasonable coverage of all the Company’s areas of business (finance; sales and marketing; human resources and payroll, investments, mergers and acquisitions; safety and security; information technology – IT; economics and logistics; engineering and planning).

Preparation of follow-up checks – at the request of the Board’s Audit Committee or the recommendation of the Internal Auditor.

In addition to the subjects determined in the annual work program, the audit prepares ‘special examinations’. These examinations are not included in the work program, and are prepared at the request of the Chairman of the Board of Directors, Chairman of the Audit Committee or the CEO.

The Audit Committee of the Board of Directors accepts and approves the work plan.

The auditor may propose subjects at her discretion. Investigations of these subjects are authorized by the CEO and the Audit Committee.

During the reporting period the auditor did not examine any material transactions.

(7) **The audit’s response to corporations comprising a material holding**

In all the corporations representing material holdings of the Company, with the exception of Bezeq On Line Ltd., there are internal auditors (either as employees or outsourced). In 2006 the Company's auditor served as internal auditor of Bezeq On Line Ltd. The audit reports are discussed in the audit committees and/or Boards of Directors of these corporations, on which senior officers of the Company serve. The Company auditor regularly receives the audit reports of the corporations which are fully held by the Company: Bezeq International Ltd. and BezeqCall Communications Ltd. (until it was merged with Bezeq International at the beginning of 2007).

At the request of the Chairman of the Board of Directors, the internal auditor prepares special audit examinations for the affiliated companies. During the year reported, the internal auditor published six reports: One at DBS, two at BezeqCall Communications Ltd. and three at Bezeq On Line Ltd.

(8) **Scope of employment**

(A) **Number of hours of employment in the year**

The audit's work program for 2006 included twelve thousand audit hours. The internal audit unit at the end of the reporting period employed fifteen fulltime employees of whom thirteen are auditors, including the internal auditor.

(B) **Scope of the internal auditor's work in the reporting period**

During the reporting period the number of employees was reduced by two from fourteen auditors to twelve (among them the internal auditor who ceased his employment in the Company). As a result of the organization change and Company's retirement program and personnel changes in the department in keeping with the requirements and qualifications of the remaining internal auditors, the number of employee in the internal audit department was reduced at the beginning of 2007 – subsequent to the reporting period – by six additional employees.

After examining the work plan for 2007, the standard for the audit department was set at six auditors of appropriate expertise and qualifications. The auditors will implement the audit plan, which amounts to approximately 10,000 work-hours, compared with 12,000 in 2006, and it was decided that if necessary, and depending on the required qualifications, the number of auditors will be re-examined during the year to ensure compliance with the annual plan.

(9) The Company's internal audit in Bezeq is prepared pursuant to the binding standards of the IIA (Institute of Internal Auditors).

Standard 1312 of the IIA requires an external audit once every five years.

In 2004, the Company's internal audit unit underwent an external audit, which concluded that the unit carries out its work in accordance with accepted professional internal audit standards.

(10) **Access to information**

The internal auditor has been furnished with documents and information as stipulated in Article 9 of the Internal Audit Law, and she has been granted permanent direct access to the Corporation's information systems.

(11) **Auditor's report**

(A) The internal auditor submits the audit reports in writing.

(B) The internal auditor routinely submits the audit reports during the reporting period to the Chairman of the Board of Directors, the CEO, the Chairman of the Audit Committee and committee members. During the reporting period 25 audit reports regarding the Company were submitted at the following times:

January – three reports
February – two reports
March – two reports
April - three reports
May – four reports
June - one report
July – three reports
September – one report
November – three reports
December – three reports

(C) **Dates on which the Audit Committee convenes**

The Board's Audit Committee regularly discusses the audit reports submitted by the internal auditor during the year reported. Over the course of the year, the Committee held

10 meetings. The following table presents the meeting dates during the year reported, divided into quarters:

First quarter	Second quarter	Third quarter	Fourth quarter
February 7, 2006	May 16, 2006	July 11, 2006	November 22, 2006
March 8, 2006		August 22, 2006	November 27, 2006 The audit reports were not discussed at this meeting
		September 12, 2006	December 26, 2006 The audit reports were not discussed at this meeting
			January 21, 2007 This meeting was held instead of the meeting which had been scheduled for December 26 and which was postponed.

26 audit reports were discussed at these meetings. Approximately 17 of the reports discussed were published during the year reported and 9 at the end of the previous year reported. In addition to discussions on the audit reports, the committee discussed additional subjects that it is obligated by law to discuss and decide thereon.

(11) **Assessment of the Board of Directors regarding the work of the Internal Auditor**

In the opinion of the Company's Board of Directors, based on that described in sections (1) – (10) above, the scope of the Company audit performed in 2006, the nature and continuity of the internal auditor’s activities, and the work program, which are reasonable in the circumstances, they are sufficient to achieve the objectives of the audit.

(12**)** **Remuneration**

(A) The internal auditor is not one of the five highest salaried of the Corporation’s senior officers.

(B) The auditor was granted options as set forth in Section (1)(E) above.

(C) The remuneration received by the internal auditor does not affect her professional judgment.

(13) **Disclosure of exposure caused by non-compliance with conditions**

The binding conditions in the matter of the Corporation’s internal auditor have been fulfilled pursuant to the fourth appendix of Article 10(b)(11) or pursuant to any law.

9. Critical accounting estimates

The preparation of the financial statements according to international accounting principles obligates the management to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities. Management bases its estimates and assessments on past experience and on estimating values and opinions and additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments based on various assumptions and conditions. Information on the principal matters of uncertainty in critical assessments and judgments in the application of the accounting policies is provided in the Financial Statements (see Note 2F). We believe that these assessments and estimates are critical because every change in them and the assumptions has the potential to materially affect the financial statements.

Estimated useful life of property, plant and equipment

The estimated useful lives of property, plant and equipment determine the depreciation expenses that will be recorded in the reporting period.

The main part of the telecommunications infrastructure is managed in accordance with asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past

experience, taking into consideration expected technological changes, Company plans or other changes. If such changes take place earlier than expected or differently from expected, the remaining useful life of such assets may be shortened. This results in an increase in future depreciation expenses. If the changes take place later than expected, the remaining useful life may be extended, and this results in a decrease in the depreciation expenses. In light of the importance of the Group's depreciation expenses in respect of the above changes, the effect on the operating results and the financial condition of the Group may be extremely significant.

Estimating the value of items of property, plant and equipment

Certain items of property, plant and equipment have been revalued to fair value upon the transition to IFRS based on their deemed cost, which was determined on the basis of their value on the transition date (January 1, 2005) in accordance with the Group's assessments based on the valuation of an external appraiser (attached as an appendix to the financial statements). In addition, the costs of dismantling, clearing and restoring sites were capitalized at the date of transition to IFRS. The residual value of the Company's copper cables was assessed by the Company, based on the opinion of an external appraiser (attached as an appendix to the financial statements).

The use of estimates and value appraisals affects the fixed asset and depreciation expenses items – see Note 9 to the Financial Statements.

Liability for employee benefits

These liabilities are based on actuarial calculations which include many calculation assumptions which may be different in practice. The assumptions relate, *inter alia*, to interest rates for discounting, mortality tables, wage creep and leaving rates – for details, see the actuary's letter attached to the financial statements.

With regard to changes in estimates in respect of employee benefits, see Note 16 to the Financial Statements.

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since the Company's business plans anticipate realization of the tax benefit. Naturally, actual business results can differ from business plans, and this can affect the future realization of the tax benefit (see Note 8 to the financial statements).

Provisions and contingent liabilities

The Group's companies have contingent liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions of extremely significant amounts are pending against Group companies.

The Company makes regular estimates of the potential liabilities associated with every claim and action. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is reasonable for the Company to bear the costs of settling claims and whether they can be reliably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with charges for the Company, in amounts materially different from the provisions included in the financial statements, if any. For details of contingent liabilities, see Notes 15 and 17 to the financial statements.

Provision for doubtful debts

The financial statements include a provision for doubtful debts calculated generally on the volume of trade receivable balances, based on assessments and past experience, and specifically in respect of debts whose collection is in doubt. Actual results may differ from the assessments and estimates made, and could affect the results of operations accordingly (see Note 6 to the financial statements).

Goodwill and the value of investment in investee companies

The value of the Company's holding in DBS and in Pelephone, for examining the need for a reduction in respect of impairment, is calculated by estimating the present value of future cash flows. The estimate is based on various forecasts, including, among others, projected cash flows for the coming years, a forecast of the number of subscribers and average revenue per user (ARPU), and the

business forecasts. These are based on assumptions, estimates and sensitivity to changes in the discounted interest rate (see Note 10 to the financial statements).

Employee stock options plan

The fair value of the options granted to Company employees was determined according to the Company's assessment, based on the opinion of an external appraiser (attached as an appendix to the financial statements). The value determined reflects the fair value of the services rendered to the Company in exchange for the options, and was measured by the Black and Scholes model and based on parameters that include the share price, the exercise price, volatility and average useful life. The value is also sensitive to a risk-free interest rate of government debentures (see Note 26 to the financial statements).

Assessment of financial instruments

The value of financial instruments is calculated according to the classification, based on market prices, present value of the cash flows and various value assessment models. The values are sensitive to changes in parameters that served as the basis for these assessments (see Note 30 to the financial statements).

10. Miscellaneous

A. **Disclosure concerning the remuneration of the external auditor**

Below are the fees in respect of the auditors of the main companies in the Group in respect of auditing services and services related to the audit for 2006:

- **The Company** – To Somekh Chaikin for 11,850 hours – approximately NIS 2,716 thousand.
- **Pelephone** – To Kesselman and Kesselman and to Somekh Chaikin, for 5,724 hours – approximately NIS 1,342 thousand.
- **DBS** – To Kesselman & Kesselman for 3,754 hours – approximately NIS 737 thousand for auditing services and tax services.
- **Bezeq International** – To Somekh Chaikin and to Brightman for 3,675 hours – approximately NIS 572 thousand for auditing services and approximately NIS 140 thousand for tax services.

B. **Event subsequent to the date of the financial statements**

On March 29, 2007, the Board of Directors of the Company resolved to appoint Dr. Yoram Danziger as external examiner, to investigate the issues arising from the immediate reports of the Company – on March 20, 2007, regarding the matter of approval of a stock options plan for employees and managers, on March 26, 2007, in the matter of the approval of grants for officers, and on March 26, 2007 in the matter of restatement – following the letters of the Securities Authority to the Company on March 25, 2007 and March 28, 2007. The external examiner, who will commence his work on April 1, 2007, is requested to submit his interim findings to the Board of Directors and to the Securities Authority by no later than April 12, 2007, and his final findings by April 26, 2007.

To remove even the slightest suspicion concerning the complete freedom of action of the external examiner and his access to all material in the Company as he deems necessary, the CEO of the Company, Yacov Gelbard, requested the consent of the Board of Directors for him to take leave of absence until the external examiner submits his interim findings as aforesaid. The Board of Directors acceded to Mr. Gelbard's request, and resolved that during his absence, the position of Acting CEO would be filled by Yitzhak (Ika) Abravanel, who is currently Deputy CEO of the Company.

We thank the managers of the Group companies, its employees and the shareholders.

Dov Weissglas	**Yacov Gelbard**
Chairman of the Board of Directors	CEO

Chapter C – Financial Statements

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2006

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Somekh Chaikin

216 Jaffa Road
PO Box 212, Jerusalem 91001
Israel

Telephone 972 2 531 2000
Fax 972 2 531 2044
Internet www.kpmg.co.il

Auditors' Report to the Shareholders of
"Bezeq" The Israel Telecommunication Corp. Limited

We have audited the accompanying consolidated balance sheets of "Bezeq" The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2006 and 2005, and the related statements of income, statements of recognised statements of income and expense, changes in shareholders' equity and cash flows for each of the two years ended on December 31, 2006. These financial statements are the responsibility of the Company's Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of consolidated subsidiaries, whose assets included in the consolidation constitute approximately 6% and approximately 6% of the total consolidated assets as at December 31, 2006 and 2005, respectively and whose revenues included in the consolidation constitute approximately 11% and 10% of the total consolidated revenues for the years ended December 31, 2006 and 2005, respectively. Furthermore, we did not audit the financial statements of associates in which the investment was approximately NIS 32 million and approximately NIS 11 million as at December 31, 2006 and 2005, respectively, and the Group's equity in their profits is approximately NIS 11 million for the year ended December 31, 2006, and equity in their losses is approximately NIS 3 million for the year ended December 31, 2005. The financial statements of those aforementioned subsidiaries and associates were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of those subsidiaries, is based solely on the said reports of the other auditors.

In addition we did not audit the financial statements of subsidiaries whose assets were included in the consolidation, according to their restatement in accordance with International Financial Reporting Standards, constitute approximately 30% of the total consolidated assets as at December 31, 2005 and whose revenues included in the consolidation, according to their restatement in accordance with International Financial Reporting Standards, constitute approximately 48% of the total consolidated revenues for the year ended on the aforementioned date. The aforementioned financial statements, according to their restatement in accordance with International Financial Reporting Standards, were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts included therein , is based solely on the said reports of the other auditors. We audited the adjustment described in Note 33 and other adjustments implemented in order to restate the 2005 financial statements in accordance with International Financial Reporting Standards (IFRSs). In our opinion these reconciliations are proper and have been applied properly.

We conducted our audits in accordance with generally accepted auditing standards in Israel, including standards prescribed by the Auditors' Regulations (Manner of Auditor's Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management of the Company, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is the Israeli member firm of KPMG International, a Swiss cooperative.

In our opinion, based on our audits and on the reports of the other auditors noted above, the financial statements referred to above present fairly in accordance with International Financial Reporting Standards (IFRSs), in all material respects, the financial position as at December 31, 2006 and 2005 and the results of operations the changes in shareholders' equity and cash flows for each of the years ended December 31, 2006 Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of annual financial statements), 1993.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters, the maximum possible exposure of which is significant:

1. The continuing opening of the communications sector to competition and the effects of regulation on the Group's financial position and operating results, as described in Note 1.

2. Contingent claims made against the Group of which the exposure cannot yet be assessed or calculated, and other contingencies as described in Notes 17B and 17C.

3. The financial position of a subsidiary, as mentioned in Note 32(3). In the opinion of the management of the subsidiary, based on the 2007 budget and on the alternative business plan, the prospects of arranging sources of finance required by the subsidiary in the forthcoming year are good.

Additionally, we draw attention to Note 33u to the Group financial statements regarding the adjustment by way of restatement of the financial statements as at December 31, 2005 and 2004 and for the year ended December 31, 2005, in order to retroactively reflect the depreciation of property, plant and equipment and the related tax effects thereon, in respect of the presentation of receipts from interconnect to the cellular networks and in respect of a reduction of lease payments of land from the Israel Lands Administration as described in the aforementioned note. These aforementioned corrections were implemented on the data presented in the Note of restatement to IFRSs in order to properly reflect the financial position of the Group in the transition to IFRSs in accordance with generally accepted accounting principles in Israel.

Somekh Chaikin
Certified Public Accountants

March 31, 2007

Consolidated Balance Sheets for the Year Ended December 31

	Note	2006 NIS thousands	2005 NIS thousands
Assets			
Cash and cash equivalents	5	**2,631,790**	2,158,773
Trade receivables	6	**2,111,451**	2,114,882
Other receivables	6	**250,657**	141,857
Inventory	3H	**204,669**	231,284
Broadcasting rights	3E	**169,017**	154,500
Investments and loans, including derivatives	7	**960,561**	2,403,413
Current tax assets		**11,105**	18,134
Total current assets		**6,339,250**	7,222,843
Trade and other receivables	6	**417,144**	361,013
Investments and loans, including derivatives	7	**342,175**	456,721
Property, plant and equipment	9	**6,492,362**	7,246,497
Intangible assets	10	**2,554,242**	2,611,034
Deferred and other expenses	11	**373,749**	391,738
Investments in associates accounted by the equity method	12	**32,122**	20,368
Deferred tax assets	8	**993,616**	1,077,624
Total non-current assets		**11, 205,410**	12,164,995
Total assets	28	**17,544,660**	19,387,838

	Note	2006 NIS thousands	2005 NIS thousands
Liabilities			
Loans and borrowing	13	**3,637,347**	3,160,652
Trade payables	14	**1,393,568**	1,548,457
Other payables, including derivatives	14	**802,747**	856,996
Current tax liabilities		**121,704**	6,218
Deferred income		**57,879**	56,111
Provisions	15	**288,851**	259,811
Employee benefits	16	**906,203**	717,723
Proposed dividend		**300,000**	-
Total current liabilities		**7,508,299**	6,605,968
Debentures	13	**3,169,441**	4,891,340
Obligations to banks	13	**480,830**	748,053
Loans from others	13	**169,182**	107,732
Loans provided by the minority in a subsidiary	13	**564,250**	505,280
Employee benefits	16	**373,036**	396,353
Deferred income and others		**37,020**	25,511
Provisions	15	**51,857**	52,359
Total non-current liabilities		**4,845,616**	6,726,628
Total liabilities	28	**12,353,915**	13,332,596
Shareholders' Equity	20		
Share capital		**6,309,133**	6,309,133
Share premium		**1,623,423**	1,623,423
Reserves		**671,820**	389,937
Deficit		**(2,849,381)**	(1,761,971)
Total equity attributable to shareholders of the Company		**5,754,995**	6,560,522
Minority equity in capital deficit of a consolidated company		**(564,250)**	(505,280)
Total shareholders' equity		**5,190,745**	6,055,242
Total shareholders' equity and liabilities		**17,544,660**	19,387,838

Dov Weissglas	**Yacov Gelbard**	**Ran Oz**
Chairman of the Board	President & CEO	Deputy CEO and CFO

Date of approval of the financial statements: March 31, 2007.

The notes to the consolidated financial statements are an integral part thereof.

Consolidated Statements of Income for the Year Ended December 31

	Note	2006 NIS thousands	2005 NIS thousands
Revenue	21	**12,231,830**	11,924,718
Costs and expenses			
Depreciation and amortisation	9, 10	**1,864,035**	1,933,777
Wages	22	**2,586,437**	2,585,780
Operating and general expenses	23	**5,966,616**	5,978,066
Other operating expenses (income), net	24	**249,540**	(99,841)
		10,666,628	10,397,782
Operating income	28	**1,565,202**	1,526,936
Financing costs	25		
Financing expenses		**694,393**	804,592
Financing income		**(356,425)**	(433,294)
		337,968	371,298
Profit after financing expenses		**1,227,234**	1,155,638
Equity in profits (losses) of associates accounted by the equity method	12	**11,184**	(3,320)
Profits before income tax		**1,238,418**	1,152,318
Income tax	8	**488,393**	532,015
Profit for the year		**750,025**	620,303
Attributable to:			
The shareholders' of the Company		**808,995**	666,411
Minority in a consolidated company		**(58,970)**	(46,108)
Profit for the year		**750,025**	620,303
Earnings per share	27		
Basic earnings per share (in NIS)		**0.311**	0.256

The notes to the consolidated financial statements are an integral part thereof.

Consolidated Statements of Recognised Income and Expense for the Year Ended December 31

	Note	2006 NIS thousands	2005 NIS thousands
Net change in fair value of financial assets classified as available for sale	7	**(1,464)**	539
Net change in fair value of financial assets classified as available for sale transferred to profit and loss	7	**(5,218)**	(104,582)
Actuarial gains (losses) from a defined benefit plan	16	**3,427**	(15,211)
Taxes in respect of income and expenses attributable directly to equity	8	**2,227**	40,692
Income and expenses recognised directly to equity		**(1,028)**	(78,562)
Profit for the period		**750,025**	620,303
Total recognised income and expense for the period		**748,997**	541,741
Attributable to:			
The shareholders' of the Company		**807,967**	587,849
Minority in a consolidated company		**(58,970)**	(46,108)
Total recognised income and expense for the period		**748,997**	541,741

The notes to the consolidated financial statements are an integral part thereof.

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Statement of Changes in Shareholders' Equity

	Share capital	Share premium	Capital reserve in respect of a transaction between a corporation and a controlling shareholder	Capital reserve in respect of assets available for sale	Retained earnings	Total	Minority interest in a capital deficit of a consolidated company	Total equity
	NIS Thousands							
	Relates to shareholders of the Company							
Balance at January 1, 2005	6,309,133	1,623,423	37,775	72,004	(2,416,571)	5,625,764	(466,842)	5,158,922
Profits for the year	-	-	-	-	666,411	666,411	(46,108)	620,303
Change in the fair value of financial assets available for sale, less tax	-	-	-	338	-	338	-	338
Profits from monetary assets available for sale attributable to profit and loss, less tax	-	-	-	(67,089)	-	(67,089)	-	(67,089)
Actuarial gains and losses in a defined benefit plan, less tax	-	-	-	-	(11,811)	(11,811)	-	(11,811)
Total profits recognised for the period						587,849	(46,108)	541,741
Payment from the State to employees in respect of Company privatisation	-	-	1,235	-	-	1,235	-	1,235
Share-based payments to Company employees from its shareholders	-	-	345,674	-	-	345,674	-	345,674
Minority interest in respect of a benefit deriving from a change in the terms of shareholder loans	-	-	-	-	-	-	7,670	7,670
Balance at December 31, 2005	6,309,133	1,623,423	384,684	5,253	(1,761,971)	6,560,522	(505,280)	6,055,242

The notes to the consolidated financial statements are an integral part thereof.

Statement of Changes in Shareholders' Equity

	Share capital	Share premium	Capital reserve in respect of a transaction between a corporation and a controlling shareholder	Capital reserve in respect of assets available for sale	Capital reserve in respect of option warrants for employees	Retained earnings	Total	Minority interest	Total equity
	NIS Thousands								
	Relates to shareholders of the Company								
Balance at January 1, 2006	**6,309,133**	**1,623,423**	**384,684**	**5,253**	**-**	**(1,761,971)**	**6,560,522**	**(505,280)**	**6,055,242**
Earnings for the year	**-**	**-**	**-**	**-**	**-**	**808,995**	**808,995**	**(58,970)**	**750,025**
Change in the fair value of financial assets available for sale, less tax	**-**	**-**	**-**	**(1,023)**	**-**	**-**	**(1,023)**		**(1,023)**
Earnings from monetary assets available for sale attributable to profit and loss, less tax	**-**	**-**	**-**	**(3,600)**	**-**	**-**	**(3,600)**	**-**	**(3,600)**
Actuarial gains and losses in a defined benefit plan, less tax	**-**	**-**	**-**	**-**	**-**	**3,595**	**3,595**	**-**	**3,595**
Total profits recognised for the period							**807,967**	**(58,970)**	**748,997**
Dividends to Company shareholders	**-**	**-**	**-**	**-**	**-**	**(1,900,000)**	**(1,900,000)**	**-**	**(1,900,000)**
Share-based payments	**-**	**-**	**-**	**-**	**286,506**	**-**	**286,506**	**-**	**286,506**
Balance at December 31, 2006	**6,309,133**	**1,623,423**	**384,684**	**630**	**286,506**	**(2,849,381)**	**5,754,995**	**(564,250)**	**5,190,745**

Regarding distribution of cash dividend in the amount of NIS 1.8 billion, in a distribution not in compliance with the earnings test See Note 20.

The notes to the consolidated financial statements are an integral part thereof.

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Statements of Cash Flows for the Year Ended December 31

	Note	2006 NIS thousands	2005 NIS thousands
Cash flows from operating activities			
Net earnings for the year		**750,025**	620,303
Adjustments:			
Depreciation	9	**1,591,054**	1,666,304
Amortisation of intangible assets	10	**247,557**	241,110
Amortisation of deferred and other charges	11	**25,424**	26,363
Gain from decrease in holdings in associates	12	**(595)**	(721)
Net financing costs	25	**440,429**	352,365
Equity in earnings of associates accounted by the equity method	12	**(11,184)**	3,320
Net capital gain principally due to disposal of property	24	**(159,017)**	(8,646)
Share-based payment transactions	26	**286,506**	345,674
Income tax expenses	8	**488,393**	532,015
Change in inventory		**23,014**	77,385
Change in trade receivables	6	**109,100**	(56,592)
Change in other receivables	6	**(107,854)**	(15,753)
Change in trade payables	14	**(56,778)**	63,009
Change in suppliers	14	**(79,046)**	(106,278)
Change in provisions	15	**27,327**	7,532
Change in broadcasting rights		**(14,517)**	(14,004)
Change in employee benefits	16	**168,758**	(403,753)
Change in deferred income		**11,509**	(13,079)
		3,740,105	3,316,554
Interest paid		**220,078**	177,451
Dividend received		**26,010**	-
Income tax paid		**(277,573)**	(332,014)
Net cash from operating activities		**3,708,620**	3,161,991
Cash flows from investment activities			
Investment in intangible assets	10	**(209,733)**	(224,318)
Proceeds from sale of property, plant and equipment	9	**47,804**	21,299
Investment in financial instruments available for sale		**(15,436)**	(15,839)
Financial assets held for trading, net		**1,491,439**	(903,068)
Purchase of property, plant and equipment	9	**(953,226)**	(1,477,412)
Investment in associates including loans, net	12	**-**	(9,403)
Proceeds from sale of investments and long-term loans		**62,729**	95,765
Purchase of investments and long-term loans		**(4,287)**	3,501)
Net cash from (used for) investment activities		**419,290**	(2,516,477)

The notes to the consolidated financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31 (Contd.)

	Note	2006 NIS thousands	2005 NIS thousands
Cash flows from financing activities			
Proceeds from issue of debentures	13	**-**	1,700,147
Receipt of loans	13	**50,000**	457,000
Repayment of debentures	13	**(280,350)**	(267,332)
Repayment of loans	13	**(1,268,656)**	(1,382,578)
Short-term credit, net	13	**43,146**	30,412
Dividends paid	20	**(1,600,000)**	-
Interest paid		**(601,752)**	(484,550)
Net cash from (for) financing activities		**(3,657,612)**	53,099
Net increase in cash and cash equivalents		**470,298**	698,613
Cash and cash equivalents at January 1		**2,158,773**	1,457,107
Effect of fluctuations in the rate of exchange on cash balances		**2,719**	3,053
Cash and cash equivalents at December 31	5	**2,631,790**	2,158,773

The notes to the consolidated financial statements are an integral part thereof.

Appendix to Statements of Cash Flows for the Year Ended December 31 (Contd.)

	2006	2005
	NIS thousands	NIS thousands
Appendix of activities not effecting cash flows		
Purchase of property, plant and equipment, other assets, materials and spare parts on credit	**141,518**	217,361
Sale of property, plant and equipment on credit	**161,800**	-

The notes to the consolidated financial statements are an integral part thereof.

NOTE 1 – THE REPORTING ENTITY

A. Bezeq – The Israel Telecommunication Corp. Ltd. ("the Company") is a company resident in Israel whose shares are traded on the Tel Aviv Stock Exchange. The official address of the Company is 132 Menachem Begin Road, Tel Aviv. The consolidated financial statements of the Company at December 31, 2006 include those of the Company and of its subsidiaries ("the Group"), as well as the rights of the Group in affiliated companies. The Group is a principal provider of communications services in Israel (see Note – Segments).

B. On October 11, 2005, control in the Company was transferred from the State to Ap.Sb.Ar. Holdings Ltd. and the Company ceased to be a government company. The Company was declared a monopoly in the main area in which it operates. An appeal filed by the Company was pending in the Antitrust Court against the non-revocation of its monopoly status in basic telephony; however, at the suggestion of the court (in view of the time elapsed since it was filed), the Company consented to withdraw the appeal and is preparing a revised appeal for submission to the Antitrust Commissioner. All the segments of operation of the Group are subject to competition. The activities of the Group are, in general, subject to government control and regulation. It is expected that the intensifying competition together with all the changes in the communications market, will have an adverse effect on the business results of the Group – an effect which the Group is unable to estimate.

NOTE 2 – BASIS OF PRESENTATION

A. Statement of implementation of International Financial Reporting Standards

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards ("IFRS"), and in addition, in accordance with the Securities Regulations (Preparation of annual financial statements), 5753-1993.

The Company first adopted IFRS in 2006, with a transition date of January 1, 2005. In these financial statements IFRS1 has been implemented, the Company's first-time adoption of IFRS. Its last financial statements prepared in accordance with generally accepted accounting standards in Israel were in respect of the year ended December 31, 2005.

An explanation as to how the transition to IFRS has affected the financial position of the Company and the results of its operations and cash flows, are provided in Note 33.

B. DEFINITIONS

In these financial statements –

(1) the Company – Bezeq, The Israel Telecommunication Corp. Limited.

(2) the Group - Bezeq, The Israel Telecommunication Corp. Limited and its investee companies, as listed in Note 32 – List of Group Entities.

(3) Subsidiaries – Companies, whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Group.

(4) Associates – Companies, including a partnership, in which the Groups's investment is stated, directly or indirectly, in the consolidated financial statements on the equity basis.

(5) Investee companies – Subsidiaries or associates.

(6) Related parties – As defined in IAS 24.

(7) Interested parties – As defined in Paragraph (1) of the definition of an "Interested Party" in a corporation, in Section 1 of the Securities Law.

(8) Controlling shareholder – As defined in the Securities Regulations (Presentation of transactions between a company and its controlling shareholder in financial statements), 5756-1996.

NOTE 2 – BASIS OF PRESENTATION (CONTD.)

C. Basis of measurement

The consolidated financial statements were prepared on the basis of historical cost except for the following items:

* Derivative financial instruments are measured at fair value.
* Financial instruments at fair value through profit and loss are measured at fair value.
* Financial assets classified as available-for-sale are measured at fair value.
* Liabilities in respect of share-based payment arrangements are measured at fair value.
* Assets stated at deemed cost, as described in Note 9.
* Liabilities in respect of decommissioning sites and the assets to which the liabilities are attributed, as described in Note 15
* Liabilities in respect of employee benefits, as described in Note 16.

The methods by which the fair value is measured are explained in Note 4.

D. Functional currency of operation and presentation currency.

The consolidated financial statements are stated in New Israel Shekels ("NIS"), which is the functional currency of the Group. The financial information is stated in NIS, rounded to the nearest thousand.

E. Activity in hyper-inflationary economic conditions

Through December 31, 2003, Israel was considered a country with a prevailing hyper-inflationary economy, and accordingly, the non-monetary items in the balance sheet (such as: property, plant and equipment except for property, plant and equipment valued at deemed cost), intangible assets and capital items) were adjusted for changes in the Consumer Price Index ("the Index") through that date. From that date onwards, the indexed amounts serve as the basis for reporting in the subsequent periods.

F. Use of estimates and judgment

When preparing the financial statements, Management is required to make judgments, estimates, assessments and assumptions that affect implementation of the accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from the estimates used.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to the accounting estimates are recognised in the period in which the estimate is revised and in future periods affected by them.

Information regarding main matters of uncertainty in estimates and judgment which are critical to the implementation of the accounting policy and have a determining effect on the amounts presented in the financial statements, are provided in the following Notes:

*Note 6 -	Provision for doubtful debts.
*Note 8 -	Utilisation of losses for tax purposes and deferred tax assets and liabilities recognised.
*Note 9 -	Estimated useful life of items of property, plant and equipment and determined deemed cost.
*Note 10 -	Measurement of recoverable amounts of cash-generating units.
*Notes 15 and 17	Provisions and contingent liabilities.
*Note 16 -	Measurement of a defined benefit obligation and employee benefits.
*Note 26 -	Measurement of share-based payments.
*Note 30 -	Financial instruments.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES

The accounting policies described below have been applied consistently to all the periods presented in these consolidated financial statements and in preparing the opening balance sheet at January 1, 2005 (the date of transition to IFRS), for the purposes of the transition to international reporting standards. The accounting policies were applied consistently by the Group entities..

A. Basis of Consolidation

(1) Subsidiaries
Subsidiaries are entitles controlled by the Group. Control exists when the Group has the ability to control the financial and operating policies of an entity in order to achieve benefits from its operations. In assessing control, Group potential voting rights that are exercisable or convertible are taken into account. The financial statements of the subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

(2) Special-purpose entity
The Company set up a special-purpose entity ("SPE") for investment purposes. SPEs are included in consolidation if, based on an assessment of the significance of the relationship with the Group and the risks and benefits of the SPE, the Group concluded that it controls the SPE. Such an entity controlled by the Group, was established with conditions which imposed strict limitations on the power of the management of the SPE to make decision and which allow the Group to enjoy all the benefits related to the activities and to the net assets of the SPE.

(3) Associates (accounted by the equity method)
Associates are entities in which the Group has a significant influence, but not control, over financial and operating policies.. Associates are accounted for in accordance with the equity method. The consolidated financial statements include the Group's share in the results of investee entities, on an equity accounted basis, subsequent to adjustments required to reconcile the accounting policy to that of the Group, from the date on which the significant influence commences until the date that significant influence ceases.

(4) Transactions eliminated on consolidation
Intragroup balances and any unrealised income and expenses arising from intragroup transactions are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates are eliminated to the against the investment up to the limit of the rights of the Group in the associate. Unrealised losses were cancelled in the same way as unrealised gains , but only to the extent that there is no evidence of impairment.

(5) Minority
Minority shareholders in a consolidated company which has a capital deficit, participated in their share of the losses of that company up to the amount of the loans and liabilities (including the interest accrued in respect of those loans) and the commitments to provide loans. Accordingly, the minority interest in the loses of the consolidated company appears as a separate item in he balance sheet.

B. Foreign currency transactions

Transactions in foreign currency are translated into the functional currency of the Group at the exchange rate ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the foreign exchange rate ruling at that date. Exchange rate differences in respect of monetary items represent the difference between the depreciated cost in the currency of operation at the commencement of the period, which is adjusted for the effective interest and the payments during the period, and the depreciated cost in the foreign currency translated at the exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currencies and measured at fair value, are translated into the functional currency at the exchange rate in effect on the date on which the fair value was determined. Exchange rate differences deriving from re-translation are recognised in the profit and loss, except for differences deriving from re-translation of shares classified as available for sale.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Financial Instruments

(1) Non-derivative financial instruments

Non-derivative financial instruments include investments in shares and debentures, customer credit and other accounts receivable, cash and cash equivalents, loans and credit received, supplier credit and other accounts payable, and debentures issued by the Group and loans taken out by the Group.

The initial recognition of non-derivative financial instruments is by the fair value method plus, in respect of instruments not stated at fair value through profit and loss, all the attributable direct costs of the transaction. Subsequent to initial recognition, non-derivative financial instruments are measured as described below.

A financial instrument is recognised when the Group takes upon itself the contractual terms of the instrument. Financial assets are disposed of when the contractual rights of the Group to the cash flows deriving from the financial assets expire, or when the Group transfers the financial assets to others without retaining control of the asset or of all the risks and benefits deriving from the asset. The purchase and sale of financial assets made in the normal way, are recognised on the date of the transaction, i.e. on the date on which the Group undertook to purchase or sell the asset. Financial liabilities are deducted when the Group's obligation, as detailed in the agreement, expires, or when it is discharged or cancelled.

Cash and cash equivalents

Cash or cash equivalents comprise cash balances and call deposits which can be withdrawn on demand (up to three months from the date of their deposit). A bank overdraft which is repayable on demand and forms an integral part of the Group's cash management is included as a component of cash and cash equivalents for the purpose of the statement of cash flows.
The accounting treatment of financing income and expenses is described in Note 3O below.

Financial instruments available for sale

The Group's investments in shares, certain debentures and a venture capital fund are classified as financial assets available for sale. Subsequent to the initial recognition, these investments are measured at fair value, where the changes in them, except for the accrual of interest, deductions, loss from impairment of value (see Note 3J1)) and profits or losses from changes in the exchange rate of monetary items classified as available for sale (see Note 3B), are recognised directly as capital. Where the investment is disposed of, the profits or losses accumulated as capital are transferred to profit and loss.

Investments measured at fair value through profit and loss

A financial instrument is classified as measured at fair value through profit and loss, if it is held for current trading or if the instrument is a derivative.

(2) Derivative financial instruments

The Group holds derivative financial instruments to hedge its exposure to foreign exchange risks and Index risks. Embedded derivatives are separated from the host contract and treated separately if: (a) there is no close relationship between the economic characteristics and the risks of the host contract and the embedded derivative; (b) a separate instrument with the same terms as the embedded instrument would meet the definition of a derivative, and (c) the embedded instrument is not measured at fair value through profit and loss.

The initial recognition of derivatives is at fair value: the attributable costs of the transaction are recognized in profit and loss upon realisation. Subsequent to initial recognition, derivative financial instruments are measured at fair value, where the movements in the fair value are recognised in income and expense as incurred.

Economic hedging

Where a derivative financial instrument is used to hedge economically monetary assets or liabilities, no hedge accounting is applied. The changes in the fair value of these derivatives are recognised in the income statement.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Financial Instruments (contd.)

Separable embedded derivatives
Changes in the fair value of separable embedded derivatives are recognised immediately in the income statement.

(3) Share capital – Ordinary shares
Incremental costs relating directly to an issue of ordinary shares and options for shares, are presented as a deduction from the capital.

D. Property, plant and equipment

(1) Recognition and measurement
The cost includes expenses attributable directly to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct wages and financing costs, as well as any additional cost attributable directly to transporting the asset to the required location and position so that it can operate in the manner intended by Management, as well as the costs of dismantling and removing the items and restoring the site on which they are located in cases where the Group has an obligation to vacate and restore the site. The cost of purchased software which is an integral part of the related asset, is recognised as part of the cost of that asset.

Where some of the property, plant and equipment have a different useful life, they are treated as separate items (material components) of the property, plant and equipment.

Under IFRS1, the Group chose a relief whereby:
(a) the liability at the date of transition to IFRS, is measured in accordance with IAS 37;
(b) the amount that would have been included as the cost of the asset on the date when the liability was first created, is stated by capitalising the liability at the same date, according to the historical capitalization rates; and additionally
(c) the accumulated depreciation on the same amount is calculated at the date of transition to IFRS.

Items of property, plant and equipment are stated at cost less accumulated depreciation and losses from impairment in value. Certain items of property, plant and equipment that had been revalued to fair value on the date of transition to IFRS, are measured on the basis of their deemed cost, being the revalued amount at the transition date (January 1, 2005), in accordance with the Group's assessments based on a third party appraisal.

(2) Subsequent costs
The cost of replacing part of a property, plant and equipment item is recognized as part of the carrying value of that item if it is probable that the future economic benefits embodied with the item will flow to the Group and that the cost of the item can be reliably measured. The costs of ongoing maintenance are recognised the income statement as incurred.

(3) Capitalisation of borrowing costs
The costs of specific borrowing and the costs of non-specific borrowing are capitalized as qualifying assets as defined in IAS 23 – Borrowing Costs, during the period required for completion and construction through the date on which they are ready for their intended use. Non-specific borrowing costs are capitalised in the same way for the same investment in qualifying assets or for that part of the period not financed by specific borrowing, using a rate which is the weighted average of the rates of cost for those borrowing sources whose cost was not specifically capitalized. Other borrowing costs are recognized in the income statement at the time they are incurred.

(4) Depreciation
Depreciation is recognised in the income statement on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment. Leased assets are depreciated over the shorter of the term of the lease and the period of use of the asset.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

D. Property, plant and equipment (contd.)

(4) Depreciation (contd,)

Leasehold improvements are depreciated over the term of the lease, which includes the option for the extension of the lease held by the Group and which it intends to exercise.

The estimated useful lives for the current period and comparative periods are as follows:

	Years	Main depreciation %
Digital switching equipment	4-20	10
Transmission and power equipment	5-10	20
Network equipment	5-20	5
Terminal equipment (cellular)	2-3	33
Subscriber equipment and public telephones	5	20
Fleet	7	15
Internet equipment	4-7	20
Office equipment	5-15	10
Electronic equipment, computers and internal communication systems	3-7	33
Cellular infrastructure equipment	5-10	10
Digital satellite decoders	6	17
Broadcasting and reception equipment (satellite)	7	15
Buildings	25	4

The method of depreciation, useful life and residual value were reassessed at every balance sheet date.

E. Broadcasting rights

Broadcasting rights are stated at cost, net of rights exercised.

The costs of purchased broadcasting rights for screening films and television programs include the amounts paid to suppliers of rights, plus the direct costs incurred for adaptation of the films and other programs for screening in Israel. The broadcasting rights are depreciated in accordance with the terms of the agreement for their purchase, on the basis of actual screenings out of the total number of screenings permitted under the agreement (where the portion not depreciated by the end of the term of the agreement is depreciated in full upon its termination), or according to the term of the rights agreement.

F. Intangible assets

(1) Goodwill

Goodwill is generated from the acquisition of subsidiaries and associates.

Acquisitions prior to January 1, 2005

As part of the transition to reporting in accordance with IFRS, the Group chose to treat, according to IFRS 3, only those business combinations which occurred after January 1, 2005. Regarding acquisitions which occurred prior to January 1, 2005, the goodwill reflects the amount recognized by the Group according to accepted accounting principles in Israel. In respect of these acquisitions, the accounting treatment was not adjusted to IFRS 3 for preparation of the opening balance sheet of the Group.

Acquisitions subsequent to January 1, 2005

In respect of acquisitions subsequent to January 1, 2005, the goodwill reflects the excess cost of the acquisition over the rights of the Group to the net fair value of the identified assets, liabilities and contingent liabilities of the acquired entity.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

F. Intangible assets (contd.)

(1) Goodwill (contd.)

Subsequent measurement
Goodwill is measured at cost less accumulated losses from impairment of value. Goodwill in respect of investments, which are accounted for by the equity method, is included at the book value of the investment.

(2) Software development costs

Software development costs are capitalised only if the costs of development of the software which are technically and commercially applicable, can be measured reliably, if a future economic benefit is expected from the development, and the Group intends and has sufficient resources to complete the development and use the software. The capitalised expense includes the cost of the materials, direct wages and overhead expenses directly attributable to preparation of the asset for its intended use. Other development expenses are recognized in the income statement as incurred.

Capitalised development costs are measured at cost less amortisation and accumulated losses from impairment of value.

(3) Subscriber acquisition

Incremental direct sale commissions paid in respect of sales and upgrades to subscribers who have signed a commitment to remain customers, are recognised as an intangible asset. Subscriber acquisition amortisation expenses are recorded in the income statement over the period of the subscriber's commitment, which is up to 36 months.

(4) Software

The Group's assets include computer systems consisting of hardware and software. Software which is an integral part of the hardware, which cannot function without the programs installed on it, is classified as property, plant and equipment. However, the licenses for the software, which are a separate item and add functionality to the hardware, are classified (mostly) as intangible assets. The depreciation in respect of software is recognized in the income statement under the straight-line method, over the estimated useful life of the asset. The estimated useful life is 3-10 years.

(5) Frequency usage rights

Frequency usage rights relate to cellular communication frequencies in respect of which the Group won a tender published by the Ministry of Communications (see Note 18(7) below).

(6) Other intangible assets

Other intangible assets purchased by the Group, which have a defined useful life, are measured at cost less amortisation and accumulated losses from impairment of value.

(7) Subsequent expenses

Subsequent expenses are capitalised only when they increase the future economic benefit inherent in the asset for which they were incurred. Any other expense, including an expense relating to amortised goodwill or brand, is recognised in the income statement as incurred.

(8) Amortisation

Amortisation, except for goodwill, is recognised in the income statement by the straight line method over the estimated useful life of the intangible assets, from the date on which the assets are available for use.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

F. Intangible assets (contd.)

(8) Amortisation (contd.)

The estimated useful lives for the current period and comparative periods are as follows:

* Capitalised development expenses	4-7 years
* Other rights	3 and 10 years, depending on the useful life
* Subscriber acquisition costs	Depending on the contractual commitment with the subscriber
* Computer programs and licenses to use them	Over the term of the license or the estimated duration of use

G. Leased properties

Leases, in which the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. At the date of initial recognition, the leased properties are valued at the lower of the fair value and the present value of the minimum lease fees. Subsequent to the initial recognition, the property is treated according to the accounting policy customary for that property.
Other leases, including leases from the Administration, are classified as operating leases, where the leased properties are not recognized in the balance sheet of the Group.
The Group applies IFRIC 4 – Determining Whether an Arrangement Contains a Lease, which defines criteria for determining the commencement of the arrangement, whether a right to use the property constitutes a lease arrangement. In addition, it defines when thereafter the arrangement should be re-examined. The Group applied the relief laid down in IFRS1, whereby the examination of whether an arrangement contains a lease was made on the basis of the facts and circumstances prevailing on January 1, 2005 (the date of transition to IFRS).

H. Prepaid expenses in respect of a right to use capacities

In accordance with IFRIC 4, as mentioned above, transactions for purchasing an indefeasible right of use ("IRU") of undersea cable capacities were treated as receipt of a service transaction. The prepaid expense balance is amortised by the straight line method over the shorter of the term stated in the agreement and the estimated useful life of those capacities.

I. Inventory

Inventory is stated at the lower of the cost and net realizable value. The cost of the inventory is determined by the moving weighted average method, and includes the expenses for purchasing the inventory and bringing it to its present place and position. The net realisable value is an estimate of the selling price during the normal course of business, less the estimated cost to completion and the estimated costs required for making the sale.

The inventory of a consolidated company includes terminal equipment intended for sale, as well as spare parts used for repairs in the repair service it provides to its customers. As part of its normal operations, the subsidiary upgrades the terminal equipment for its customers, and therefore the inventory also includes used handsets and accessories returned by customers.

J. Impairment

(1) Financial assets

The Group reviews a monetary asset for impairment when there is objective evidence that one or more events have impacted negatively on the estimated future cash flows of the asset.

A loss from impairment of a monetary asset, which is stated at net book value, is calculated as the difference between the book value of the asset and the present value of the estimated future cash flows, discounted at the original effective interest rate. A loss from impairment of a monetary asset, classified as available for sale, is calculated on the basis of its current fair value.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

J. Impairment (contd.)

Review of the requirement for impairment in value, in respect of monetary assets with significant amounts, is made for each asset separately. The requirement to review the remainder of the other monetary assets is assessed collectively, in groups with similar credit risk characteristics. In addition, the financial statements include specific provisions for doubtful debts, which properly reflect, according to Management's assessment, the loss grossed up with the debts in debts whose collection is in doubt..

All the losses from impairment are recognized in the income statement. An accumulated loss relating to a monetary asset classified as available for sale, which was formerly charged to capital, was transferred to the income statement when the asset value became impaired.

A loss from impairment is reversed when it can be objectively attributed to an event that occurred after recognition of the loss from impairment. Reversal of a loss from impairment of monetary assets is stated at depreciated cost, and in respect of financial assets classified as available for sale which are debt instruments, are recognized in the income statement. Reversal of the loss from impairment in respect of a monetary asset classified as available for sale which is shares, is charged directly to capital.

(2) Non-monetary assets

The book value of the Group's non-monetary assets which are not inventory or deferred tax assets, is reviewed at each reporting date to determine whether there are any indications of impairment. If there are such indications, the estimated recoverable amount of the asset is calculated. On January 1, 2005 the date of transition to the IFRS, the Group reviewed goodwill, for impairment. In subsequent periods, the Group makes an assessment, every year, of the recoverable amount of goodwill and assets which are not available for use.

An impairment loss is recognized whenever the carrying amount of an asset or its cash-generating unit to which the asset belongs, exceeds its recoverable amount. A cash-generating unit is the smallest identified group of assets that generates cash flows, largely independent of assets in other groups.

Impairment losses are recognized in the income statement. Losses from impairment which were recognized for cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to cash-generating units, and then to a reduce the carrying amount of the other assets in the unit on a pro rata basis.

The recoverable amount of an asset or of a cash-generating unit is the greater of the value in use and the net selling price (fair value less selling costs). In determining the value in use, the Group capitalizes the net present value of the estimated future cash flows before taxes, which reflects the market assessments for the time value of the money and the specific risks related to the asset.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses which were recognized in prior periods are reviewed on each reporting date to determine whether there are any indications that the losses have been reduced or no longer exist. A loss from impairment is reversed if there has been a change in the estimates used to determine the recoverable amount, only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if the loss from impairment had not been recognised.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

K. Non-current assets held for sale

Non-current assets (or groups designated for disposal that include assets and liabilities) which are expected to be realized by way of sale and not by way of continued use are classified as assets held for sale. Immediately prior to their classification as assets held for sale, the assets (or the components of groups designated for disposal), are stated according to the Group's accounting policies. Thereafter, the assets (or groups designated for disposal) are stated at the lower of the book value and the fair value, less selling costs. Every loss from impairment of the group designated for disposal is initially attributed to goodwill, and thereafter, pro rata, to the remaining assets and liabilities, except that a loss is not attributed to inventory, to monetary assets, deferred tax assets or employee benefit assets, which continue to be measured by the accounting policies of the Group. Losses from impairment at the time of initial classification of an asset classified as held for sale, and subsequent gains or losses as a result of re-measurement, are recognised in the income statement. Gains are recognized up to the accumulated amount of a loss from impairment recorded in the past.

L. Employee benefits

The Group has a number of retirement benefit plans. The plans are usually financed by deposits in insurance companies, and are classified as defined contribution plans and as defined benefit plans.

(1) Defined contribution plans
The Group's commitments to make deposits in a defined contribution plan, are recognized in the income statement as an expense on the date on which the commitment to make the deposits is made.

(2) Defined benefit plans
The Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of the future benefit that employees have earned in return for their service in the current and in prior periods. That benefit is stated at present value less the fair value of the plan's assets. The discount rate is the yield at the balance sheet date, on government bonds, whose currency and maturity dates are similar to the terms of the Group's obligations. The calculation is performed by a qualified actuary using the projected unit credit method.

Where the benefits of a plan are improved, the portion of the increased benefit relating to past service by employees is recognised as an expense in the income statement on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits vest immediately, the expense is recognised as incurred in the income statement.

The Group recognises as incurred directly to equity, all the actuarial gains and losses derived from a defined benefit plan.

The actuarial gains and losses at January 1, 2005, the date of transition to IFRS, were charged to reserves.

(3) Other long-term service benefits
The Group's net obligation in respect of long-term service benefits, other than pension plans, is the amount of future benefit that employees have earned in return for their services in the current and prior periods. The amount of the benefits is capitalised at their present value, net of the fair value of the assets related to this commitment. The discount rate is the yield at the balance sheet date on corporate bonds that have maturity dates approximating to the terms of the Group's obligations. The obligation is calculated using the projected credit method and is discounted to its present value and the fair value of any related assets is deducted. Actuarial gains and losses are recognized in the income statement in the period in which they arise.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

L. Employee benefits (contd.)

(4) Severance pay and voluntary retirement benefits

Employee severance pay is recognised as an expense when the Group has a clear obligation, with no real possibility of cancellation, for employee terminations before they reach the accepted retirement date according to a detailed formal plan. Employee benefits upon voluntary retirement are recognised when the Group proposes a plan encouraging voluntary retirement to the employees, the plan is expected to be accepted and the number of those who will benefit from the plan can be reliably estimated.

(5) Short-term benefits

Obligations in respect of short-term service benefits are measured on a non-equity basis, and the expense is recognised at the time the relevant service is rendered. A provision for short-term service benefits in respect of a cash bonus or a profit-sharing plan, is recognized when the Group has a legal or constructive obligation to pay an amount for a service rendered by the employee in the past, and that amount can be reliably estimated.

(6) Share-based payment transactions

The fair value of options granted is recognised as an employee expense with a corresponding increase in equity and spread over the period during which the employee become unconditionally entitled to the options. The amount recognised as an expense is adjusted to reflect the actual number of share options that vest.

The fair value of the options granted to the employees by the State for the period when the State was the controlling shareholder of the Company was recognised at the date the employees were entitled to the options.

M. Provisions

A provision is recognized when the Group has a present legal or constructive obligation as a result of a past event, which can be reliably estimated and it is probable that an outflow of economic benefits will be required to settle the obligation. The provisions are measured by discounting the expected future cash flows at a pre-tax interest rate that reflects current market assessments for the time value of the money and the risks specific to the liability.

(1) Contingent liabilities

The financial statements include appropriate provisions in respect of claims against the Group companies which in the opinion of those companies will not be dismissed or abated, despite the fact that the claims are denied by the Group companies. In addition, there is also a low number of legal proceedings, recently received, the risks of which cannot be assessed at this stage, and therefore no provisions have been made in respect thereof.

The treatment of pending legal claims is according to IAS 37 and its related provisions. Accordingly, the claims are classified by probability of realisation of the exposure to risks, as follows:

1. Probable – more than 50% probability.
2. Possible – more than remote and less than or equal to 50% .
3. Remote – probability less than or equal to 20%.

Regarding claims which are probable, the financial statements include provisions which in the opinion of the Group's Management, based, among others, on the opinions of its legal advisers retained in respect of those claims, are appropriate to the circumstances of each case.

Note 17 contains details of the additional exposure due to contingent claims whose amounts are significant, and in which the likelihood of realisation is possible or remote.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

M. Provisions (contd.)

(2) Restructuring
A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring has either commenced or has been announced publicly. Future costs are not provided for.

(3) Onerous contracts
A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its obligation under the contract. The provision is recognised at the lower of the present value of the cost of contract cancellation and the present value of the net cost of meeting the contract obligations.

(4) Site dismantling and clearing costs
A provision in respect of an obligation to dismantle and clear sites is recognised in accordance with IAS 37. The provision is recognised in respect of those rental agreements under which the Group is obliged at the end of the rental period to restore the rental property to its original state, after dismantling and transferring the site and restoration of the site as necessary. In connection with recognition of a provision for the costs of dismantling and clearing sites at the date of transition to IFRS, the Group selected the relief in accordance with IFRS1, as described in Note 3D(1).

(5) Warranty
A consolidated company recognised a provision for warranty in respect of first-year insurance for cellular handsets. The warranty is limited to technical malfunctions defined by the Company, and does not include warranty as a result of customer damages. However, an asset exists in respect of the manufacturer's warranty for those handsets, which is limited to technical malfunctions defined by the manufacturer.

N. Income

The Group's income consists mainly of revenues from fixed-line communication services, cellular services, international communication services, satellite television services, customer centre services, provision of communication services for other communications providers, sale and installation of communications equipment, and internet services. Revenues are measured at the fair value of the consideration received or about to be received, less returns, commercial discounts and quantity discounts.

(1) Equipment sales
Revenue from sales of equipment are recorded at the time of delivery to the customer, upon transfer of the main risks and rewards related to ownership of the equipment sold.

(2) Services
Revenue from services is charged proportionately over the term of the agreement or upon providing the service if the flow of the economic benefits associated with providing the service is certain. Revenue from calls, including revenue from prepaid call cards, are recognised when the call is made by the customer.

(3) Operating lease
Lease payments are recognised in income and expense by the straight line method, over the term of the lease. Lease incentives granted are recognised as an integral part of all revenues from rentals, over the term of the lease.

(4) Interest and dividends
Interest income on debentures and loans is recognised in income and expense on a cumulative basis, using the effective interest method. Income from dividend is charged to the income statement on the effective date of entitlement to a dividend.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

N. Income (contd.)

(5) Sales on credit

Revenues from sales transactions on credit that include a financing transaction, are recorded at their present value, so that the difference between the fair value of the transaction and the stated amount of the consideration will be recognised inthe income statement as interest income, using the effective interest rate.

(6) Multi-component sale agreements

Revenues from sale agreements that do not contain a general right for return, which include a number of components, such as an appliance, service, and support agreements, are split into separate accounting units and recognised separately for each accounting unit. A component constitutes a separate accounting unit if, and only if, it has a separate value for the customer. In addition, there is reliable and objective evidence of the fair value of all the components in the agreement / the fair value of the components not yet supplied. Components not split into an accounting unit due to non-compliance with the conditions described above, are grouped together into one accounting unit. Recognition of revenues from the various accounting units takes place when the conditions are met for recognition of revenues from the components in that accounting unit, depending on their type, and only up to the amount of the consideration which is not contingent upon completion / performance of the other components in the contract.

(7) Reporting revenues on a gross or net basis

In cases where the Group acts as agent or broker without bearing the risks and returns arising from the transaction, its revenues are stated net. Conversely, where the Group acts as main supplier and bears the risks and returns arising from the transaction, its revenues are stated gross.

(8) Lease of satellite decoders

A consolidated company collects deposits from its customers for the digital satellite decoders situated on the customer site, in an amount which does not exceed the cost of the decoders, and at the end of the agreement, the customers are entitled to the remaining portion of the deposit in accordance with in their agreement.

Revenues from deduction of the deposit are recognised in the income statement, in accordance with the terms of the agreement with the customers (over five or 10 years).

O. Financing income and expenses

Financing income includes interest income in respect of amounts invested, income from dividends, interest income from recognising deferred income in respect of the sale of terminal equipment in instalments, gains from the sale of monetary assets classified as available for sale, changes in the fair value of monetary assets stated at fair value through income, gains from foreign currency and gains from hedging instruments recognised in profit and loss. Interest income is recognised as accrued, using the effective interest method. Dividend income is recognised on the date on which the Company’s right to receive payment is established which in the case of quoted securities is usually the ex-dividend date.

Financing expenses include interest expenses on loans received, debentures issued, commissions paid, changes in the time value in respect of provisions, foreign currency losses, changes in the fair value of monetary assets stated at fair value in income, losses from impairment in value of monetary assets and losses from hedging instruments recognised in income. All borrowing costs are recognised in the profit and loss using the effective interest rate.

P. Income tax expense

Income tax expense comprises current and deferred taxes and is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.
Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted a the balance sheet date, and any adjustment to tax payable in respect of previous years.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

P. Income tax expense (contd.)

Deferred taxes are provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts to be used for taxation purposes. Deferred taxes for the following temporary differences are not recognised: initial recognition of goodwill, initial recognition of assets and liabilities in a business combination transaction which does affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries and jointly-controlled entities to the extent that they will probably not reverse in the foreseeable future. The amount of deferred taxes is measured using tax rates expected to be applicable to the temporary timing differences at the date of their realisation, based on laws enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised to the extent that it is probable that future taxable profit will be available against which the deductible temporary differences may be utilised. Deferred tax assets are reviewed at each balance sheet date, and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Additional income taxes that arise from the distribution of dividends are recognised at the same time as the liability to pay the related dividend.

Q. Earnings per share

The Group presents basic and diluted earnings per share data in respect of its ordinary share capital. The basic earnings per share is calculated by dividing the profit or loss attributed to the ordinary shareholders of the Group by the weighted average number of ordinary shares which were in circulation during the period. The diluted earnings per share is determined by adjustment of the loss or gain to the ordinary shareholders and adjustment of the weighted average of the ordinary shares in circulation for the effects of all the potential dilutions to ordinary shares, including notes convertible to shares, share options and share options granted to employees.

R. Segment reporting

A segment is a distinguishable component of the Company that is engaged in providing services to each other (business segment) which is subject to risks and rewards that are different those other segments. The main form of the Company's segment reporting is based on business segments.

S. Dividend declared subsequent to the balance sheet date

An obligation relating to a dividend proposed or declared subsequent to balance sheet date is recognised only in the period in which the declaration was made.

T. New standards and interpretations not yet adopted

A number of new standards, amendments to existing standards and interpretations, were not yet effective on December 31, 2006, and therefore were not applied in the preparation of these consolidated financial statements.

IFRS 7 – Financial Instruments: Disclosures and the amendment to IAS 1 – Presentation of Financial Statements: Capital Disclosures, require extensive disclosures concerning the significance of the financial instruments on the financial position and performance of the Group, and disclosures of quality and quantity regarding the nature and scope of the risks. IFRS 7 and the amended IAS 1, will be applicable to the financials statements of the Group for 2007 and will require additional extensive disclosures relating to Group financial instruments and share capital.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

T. New standards and interpretations not yet adopted (contd.)

IFRIC 7 – Financial Reporting in Applying the Restatement Approach under IAS 29 in Hyperinflationary Economies, relates to the application of IAS29 when an economy becomes hyperinflationary for the first time, and in particular the accounting treatment related to deferred tax. IFRIC 7, which will apply to the financial statements of the Group for 2007, is not likely to affect the consolidated financial statements.

IFRIC 8 – Scope of IFRS 2 – Share-based Payment, relates to the accounting treatment of share-based payment transactions in which some or all of the goods or services received cannot be specifically identified, IFRIC 8 will apply to the financial statements of the Group for 2007, and adoption will be by way of retroactive application. The effect of IFRIC 8 on the consolidated financial statements depends on the existence of of the type of the aforementioned transactions..

IFRIC 9 – Reassessment of Embedded Derivatives, determines that reassessment with regard to the need to separate an embedded derivative from a host contract will arise only when changes in the contract occur. The effect of IFRIC 9, which will apply to the financial statements of the Group for 2007, depends on the existence of the aforementioned changes.

IFRIC 10 – Interim Financial Reporting and Impairment, prohibits the cancellation of a loss from impairment which was recognised in a prior interim period in respect of goodwill, investment in a capital instrument or a monetary asset stated on a cost basis. IFRIC 10 will apply to the financial statements of the Group for 2007. The adoption of IFRIC 10 is not likely to affect the consolidated financial statements of the Group.

IFRIC 11 – Group and Treasury Share Transactions is an interpretation dealing with the application of IFRS 2: Share-based Payment, in share-based transactions related to the capital instruments of the corporation itself or the equity instruments of another corporation in the same group. IFRIC 11 will be applicable to the annual periods commencing March 1, 2007 or thereafter. Early adoption is permitted. The effects of adoption of IFRIC 11 on the consolidated financial statements depends on future grants of share-based payments by the Group.

IFRIC 12 – Service Concession Arrangements is an interpretation relating to the accounting treatment of operators from the private sector which provide public infrastructure assets and services. IFRIC 12 creates a distinction between two types of arrangements for service concessions. In one, the operator receives a monetary asset, an unconditional contractual right to receive cash or a other monetary asset from the government in exchange for the construction or upgrading of a public asset. In the other, the operator receives an intangible asset, a right to collect payment for the use of the public asset it is constructing or upgrading. The right to collect payment from users is not an unconditional right to receive cash, since the amounts depend on the scope of use the public will make of the service. The interpretation will apply to annual periods commencing on January 1, 2008 or thereafter, and early adoption is permitted. The adoption of IFRIC 12 is not likely to affect the consolidated financial statements.

IFRS 8 – Segment Reporting, describes how a corporation should report on segment operations in the annual financial statements, and relates to selected details concerning segments in interim reports. In addition, the standard relates to the disclosure required regarding products and services, geographical areas and principal accounts. The standard allows the corporation to determine the rationale for division into segments, so that segmental reporting will be based on factors under Management's supervision for operational decision-making. The standard will apply to annual periods commencing on January 1, 2009 thereafter. The standard permits early application, and requires amendment of comparative numbers on adoption of the standard. The adoption of IFRS 8 is not likely to significantly affect the consolidated financial statements.

NOTE 4 – DETERMINING FAIR VALUE

The accounting policies and the disclosure requirements require the Group to determine the fair value of monetary and non-monetary assets and liabilities. The fair values were determined for the purposes of measurement and/or disclosure using the methods described below. Additional information regarding the assumptions used in determining the fair values can be found in the notes relevant to the particular asset or liability.

A. Property, plant and equipment

Certain items of property, plant and equipment were revalued at fair value on the date of transition to IFRS. Determination of the deemed cost of the items is based on an assessment of the value performed by an external appraiser using the depreciated replacement cost method.

B. Investments in shares and debentures

The fair value of monetary assets is measured at fair value through profit and loss, which are classified as available for sale, is determined using their offer price in the market or according to a model for non-negotiable assets at the balance sheet date.

C. Customers and other trade receivables

The fair value of customers and other long-term trade receivables was determined using the present value of the future cash flows, discounted at the market interest rate on the balance sheet date.

D. Derivatives

The fair value of foreign currency or Indexed forward contracts is based on their quoted market prices, if available and if unavailable, particularly regarding embedded derivatives, according to estimated value.

E. Non-derivative financial liabilities

The fair value, determined for disclosure, is calculated at the present value of the future cash flows in respect of the principal and the interest, discounted at the market interest rate on the balance sheet date.

F. Share-based payments

The fair value of stock options for employees is measured using the Black and Scholes model. The assumptions of the model include the share price on the date of measurement, the exercise price of the instrument, expected volatility (based on the weighted average of historical volatility, adjusted for changes expected from information available to the public), the weighted average of the projected useful life of the instruments (based on past experience and the general behaviour of the option-holders), expected dividends, and the risk-free interest rate (based on government bonds). Conditions of service and performance which are not market conditions, are not taken into account in determining the fair value.

NOTE 5 – CASH AND CASH EQUIVALENTS

	Consolidated	
	December 31 2006	December 31 2005
	NIS thousands	NIS thousands
Bank balances	**66,015**	75,591
Demand deposits	**2,565,775**	2,083,182
Cash and cash equivalents	**2,631,790**	2,158,773

The effective interest rate on the demand deposits in 2006 was 4.8% - 5.3% (2005 – 3.7% - 4.3%). For deposits, the average maturity period was 3-7 days (2005 – 5-7 days).

NOTE 6 –TRADE AND OTHER RECEIVABLES

	Consolidated	
	December 31 2006	December 31 2005
	NIS thousands	NIS thousands
Trade receivables		
Trade receivables that are related parties and interested parties	**98,129**	92,247
Open debts	**912,352**	997,291
Credit cards and checks for collection	**455,021**	415,059
Others	**202,978**	218,955
Current maturities of long-term trade receivables	**442,971**	391,330
	2,111,451	2,114,882
Receivables		
Government institutions	**1,309**	-
Prepaid expenses	**93,977**	126,971
Other receivables	**155,371**	14,886
	250,657	141,857
Long-term trade receivables (1)	**388,652**	359,900
Other long-term receivables (1)	**28,492**	1,113
	417,144	361,013
	2,779,252	2,617,752

(1) For the repayment dates and the discounted interest rates, see Note 30.

At December 31, 2006, trade receivables are shown net of the provision for doubtful debts in the amount of NIS 289,010 thousand (2005 – NIS 338,062 thousand). The loss from impairment recognised in the current year amounted to NIS 55,920 thousand (2005 – NIS 69,166 thousand).

Trade and other receivables denominated in currencies which are not the functional currency include NIS 74,045 thousand of receivables denominated in US dollars (2005 – NIS 52,256 thousand), and NIS 7,421 thousand of receivables denominated in euro (2005 – NIS 2,189 thousand).

NOTE 7 – INVESTMENTS AND LOANS, INCLUDING DERIVATIVES

A. Segmentation by investment classification

	Consolidated	
	December 31 2006	December 31 2005
	NIS thousands	NIS thousands
Current investments		
Financial assets measured at fair value trough profit and loss	**893,975**	2,316,826
Structured instruments (1)	**60,361**	-
Financial assets available for sale (2)	**-**	78,547
Derivatives	**2,983**	4,458
Other investments	**3,242**	3,582
	960,561	2,403,413
Non-current investments		
Bank deposit for providing loans to employees (3)	**185,291**	192,621
Structured instruments (1)	**-**	65,597
Financial assets available for sale	**121,123**	119,157
Loans and long-term debit balances	**35,761**	79,346
	342,175	456,721
	1,302,736	2,860,134

(1) The carrying amount of structured instruments includes debentures. The instruments are dollar-linked and bear LIBOR for six months and three months plus a margin of 3.4% and 1.65%, respectively.

(2) The carrying amount of an interest-bearing financial asset available for sale at December 31, 2006, is NIS 78,547 thousand. The asset, which bears interest at 4%, was realised in 2006.

(3) The deposit is used as collateral for the provision of bank loans to Company employees. The deposit is unlinked, and the effective interest rate at December 31, 2006 is 2.93% (2005 – 2.53%). The Company is liable for loans to employees. The deposit is shown at its present value, taking into account the repayment schedule of the loans, based on a discounted rate of 5.56% on average (2005 – 5.84%). Deferred salary expenses were added to the deposit amount.

NOTE 7 – OTHER INVESTMENTS, INCLUDING DERIVATIVES (CONTD.)

B. Segmentation by types of securities

	December 31, 2006			December 31, 2005		
	Marketable	Others	Total	Marketable	Others	Total
	Equity value	Equity value	Equity value	Equity value	Equity value	Equity value
	NIS thousands			NIS thousands		
Government bonds –						
Linked to the consumer price index	**188,939**	**-**	**188,939**	764,631	-	764,631
Unlinked	**200,496**	**-**	**200,496**	372,075	-	372,075
Linked to the dollar	**482**	**-**	**482**	1,740	-	1,740
Corporate debenture	**329,297**	**-**	**329,297**	639,923	-	639,923
Foreign securities	**55,360**	**-**	**55,360**	245,642	-	245,642
Short-term loan	**88,493**	**-**	**88,493**	143,547	-	143,547
Investments in shares and options	**28,957**	**74,675**	**103,632**	63,999	79,932	143,931
Participation in trust funds	**7,972**	**-**	**7,972**	161,578	-	161,578
Investments in debentures convertible to shares	**1,800**	**-**	**1,800**	5,361	-	5,361
Structured instruments	**-**	**60,361**	**60,361**	-	65,597	65,597
Bank deposit for providing loans to employees	**-**	**185,291**	**185,291**	-	192,621	192,621
Investment in hedge fund	**-**	**38,627**	**38,627**	-	36,102	36,102
Loans and long-term debit balances	**-**	**35,761**	**35,761**	-	79,346	79,346
Other investments	**-**	**6,225**	**6,225**	-	8,040	8,040
	901,796	**400,940**	**1,302,736**	2,398,496	461,638	2,860,134

C. Details of linkage base and interest terms – non-current investments

	December 31, 2006				
	Interest %	Unlinked	CPI-linked	Linked to foreign currency	Total
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deposit in bank for providing loans for employees	2.93%	**185,291**	**–**	**–**	**185,291**
Capital notes	5.85%	**–**	**15,497**	**–**	**15,497**
Loan	6.25%	**–**	**20,264**	**–**	**20,264**
Financial asset available for sale	Interest-free	**–**	–	**38,627**	**38,627**
		185,291	**35,761**	**38,627**	**259,679**

	December 31, 2005				
	Interest %	Unlinked	CPI-linked	Linked to foreign currency	Total
		NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deposit in bank for providing loans for employees	2.53%	192,621	–	–	192,621
Capital notes	5.8%-5.85%	–	56,990	–	56,990
Loan	6.25%	–	22,356	–	22,356
Financial asset available for sale	Without interest	–	–	36,102	36,102
Structured instruments	LIBOR 3 months + 1.65%	–	–	32,799	32,799
Structured instruments	LIBOR 6 months + 3.4%	–	–	32,798	32,798
		192,621	79,346	101,699	373,666

NOTE 8 – INCOME TAX

A. General

	2006	2005
	NIS thousands	NIS thousands
Current tax expense		
In respect of the current period	**397,180**	307,680
Adjustments in respect of prior years	**4,978**	(29,281)
	402,158	278,399
Deferred tax expense		
Reduction in the tax rate	**-**	83,529
Origination and reversal of temporary differences	**91,228**	195,127
Movement in the value of temporary differences not recognised	**(4,993)**	(25,040)
	86,235	253,616
Income tax expense from ongoing activities	**488,393**	532,015

B. Reconciliation of effective tax rate

	2006	2005
	NIS thousands	NIS thousands
Net earnings	**750,025**	620,303
Income tax	**488,393**	532,015
Earnings before tax	**1,238,418**	1,152,318
Statutory tax rate	**31%**	34%
Income tax at the local tax rate applicable to the group	**383,910**	391,788
Differences in the tax rate	**7,479**	83,529
Differences in definition of capital and assets	**(5,316)**	(60,272)
Expenses not recognised for tax purposes	**15,443**	48,002
Recognition of losses for tax purposes not previously recognised	**-**	4,514
Deferred taxes due to temporary differences not previously recognised	**(4,993)**	(25,040)
Losses generated during the period, for which a deferred tax asset was not recognised	**87,644**	129,023
Agreed tax assessments	**-**	(7,619)
Losses of a partnership	**665**	(3,550)
Change in temporary provisions not recognised	**(3,610)**	(12,029)
Taxes in respect of prior years	**4,978**	(29,281)
Others	**2,193**	12,950
	488,393	532,015

C. Income tax attributable directly to equity

	2006	2005
	NIS thousands	NIS thousands
Financial assets classified as available for sale	**(6,682)**	(104,043)
Actuarial gains and losses	**3,427**	(15,211)
Expenses recognised directly in equity	**(3,255)**	(119,254)
Total tax recognised directly in equity	**2,227**	40,692

NOTE 8 – INCOME TAX (CONTD.)

D. Deferred tax assets that were not recognised

Calculation of the deferred taxes does not take into account the taxes that would be applicable in case of realisation of the investment in subsidiaries and associates, since the Group intends to retain the investment. Deferred taxes in respect of a distribution of profit in those subsidiaries and associates were also not taken into account, since the dividends are not taxable. In addition, unutilised deferred tax assets in respect of losses carried forward and tax assets carried forward, were not recognised in cases where future taxable income against which they can be utilised, is not foreseen.

Deferred tax assets not recognised

Deferred tax assets were not recognised in respect of the following items:

	2006	2005
	NIS thousands	NIS thousands
Deductible temporary differences	**18,247**	7,951
Losses for tax purposes	**225,148**	337,174
	243,395	345,125

Under existing tax laws, there is no time limit on utilising tax losses or on utilising deductible temporary differences. Deferred tax assets were not recognised in respect of these items since it is not anticipated that there will be taxable income against which the tax benefits may be utilised.

E. Recognised deferred tax assets and liabilities

Tax assets and deferred tax liabilities are attributed to the following items:

	Assets		Liabilities		Net	
	2006	2005	2006	2005	2006	2005
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Property, plant and equipment	**56,519**	94,036	**70,407**	7,109	**(13,888)**	86,927
Doubtful debts	**51,102**	65,233	**–**	–	**51,102**	65,233
Intangible assets	**–**	–	**9,517**	5,527	**(9,517)**	(5,527)
Monetary assets measured at fair value through profit and loss	**3,856**	–	**1,929**	11,915	**1,927**	(11,915)
Monetary assets classified as available for sale	**3,477**	4,483	**1,283**	980	**2,194**	3,503
Derivatives	**–**	357	**233**	–	**(233)**	357
Employee benefit plan	**546,981**	479,794	**–**	–	**546,981**	479,794
Share-based payments	**135,755**	64,255	**–**	–	**135,755**	64,255
Provisions	**4,611**	5,920	**–**	–	**4,611**	5,920
Other assets	**10,936**	9,417	**–**	–	**10,936**	9,417
Deferred expenses in connection with agreed assessments	**9,330**	14,111	**–**	–	**9,330**	14,111
Losses from partnerships	**3,098**	–	**–**	–	**3,098**	–
Tax losses carried forward	**251,320**	365,549	**–**	–	**251,320**	365,549
	1,076,985	1,103,155	**83,369**	25,531	**993,616**	1,077,624

NOTE 8 – INCOME TAX (CONTD.)

F. Changes in temporary differences during the year

	Balance at January 1, 2005	Recognised in profit and loss	Recognised in equity	Balance at December 31, 2005	Recognised in profit and loss	Recognised in equity	Balance at December 31, 2006
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Property, plant and equipment	66,671	20,256	-	86,927	**(100,815)**	**-**	**(13,888)**
Doubtful debts	85,475	(20,242)	-	65,233	**(14,131)**	**-**	**51,102**
Intangible assets	(7,091)	1,564	-	(5,527)	**(3,990)**	**-**	**(9,517)**
Monetary assets measured at fair value through profit and loss	(21,982)	10,067	-	(11,915)	**13,842**	**-**	**1,927**
Monetary assets available for sale	(24,802)	(8,988)	37,293	3,503	**(3,368)**	**2,059**	**2,194**
Derivatives	-	357	-	357	**(590)**	**-**	**(233)**
Employee benefits	629,820	(153,425)	3,399	479,794	**67,019**	**168**	**546,981**
Share-based payments	-	64,255	-	64,255	**71,500**	**-**	**135,755**
Provisions	38,479	(32,559)	-	5,920	**(1,309)**	**-**	**4,611**
Deferred expenses in connection with other items	9,270	147	-	9,417	**1,519**	**-**	**10,936**
Agreed assessments	17,607	(3,496)	-	14,111	**(4,781)**	**-**	**9,330**
Losses and partnerships	-	-	-	-	**3,098**	**-**	**3,098**
Losses carried forward for tax purposes	497,101	(131,552))	-	365,549	**(114,229)**	**-**	**251,320**
	1,290,548	(253,616)	40,692	1,077,624	**(86,235)**	**2,227**	**993,616**

G. Changes during the year in unrecognised deferred tax assets and liabilities

	Balance at January 1, 2005	Changes	Amounts recognised	Balance at December 31, 2005	Changes	Amounts recognised	Balance at December 31, 2006
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deductible temporary differences (taxable)	68,779	(12,521)	(25,040)	31,218	**1,774**	**(4,993)**	**27,999**
Losses for tax purposes	900,000	113,346	(195,413)	817,933	**69,364**	**(13,077)**	**874,220**
	968,779	100,825	(220,453)	849,151	**71,138**	**(18,070)**	**902,219**

NOTE 8 – INCOME TAX (CONTD.)

H. Amendments to the Income Tax Ordinance

On July 25, 2005, the Knesset passed the Amendment to the Income Tax Ordinance Law (Number 147 and temporary order), 5765-2005 ("Amendment 147"). Amendment 147 provides for a gradual reduction in the corporate tax rate in the following manner:
In the 2006 tax year, the corporate tax rate will be 31%, in 2007 the rate will be 29%, in 2008 – 27%, in 2009 – 26% and from 2010 and thereafter, the corporate tax rate will be 25%. In addition, commencing in 2010 and with the reduction in the company tax rate to 25%, any real capital gain will be taxed at 25%.

Current taxes and deferred tax balances at December 31, 2005 and at December 31, 2006 are calculated at the new tax rates as provided in Amendment 147. The effect of the change on the consolidated financial statements at the beginning of 2005 is an increase in the income tax expense in the income statement and a decrease in the deferred taxes included in the consolidated balance sheet in the amount of NIS 83 million.

I. Final tax assessments

(1) The Company, Bezeq International, Pelephone, Bezeq On Line and Bezeqcall have final assessments up to and including the 2003 tax year.

(2) BezeqCall Communications has a final tax assessment up to and including the 2002 tax year.

(3) DBS has received final tax assessments up to and including the year 2004.

J. Effect of IFRS on the tax liability

The Income Tax Authority set up a committee to make recommendations concerning the effects of application of IFRS on the tax liability. The recommendations have not yet been published.

NOTE 9 – PROPERTY, PLANT AND EQUIPMENT

A. Composition and movement

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
				NIS thousands			
Cost or deemed cost							
Balance at January 1, 2005	1,997,039	7,166,935	12,007,631	2,547,166	190,735	1,144,385	25,053,891
Additions	48,811	583,799	169,133	426,793	4,796	152,294	1,385,626
Disposals (d)	(4,871)	(3,801,531)	(24,625)	(137,992)	(46,765)	(74,039)	(4,089,823)
Balance at December 31, 2005	2,040,979	3,949,203	12,152,139	2,835,967	148,766	1,222,640	22,349,694
Balance at January 1, 2006	**2,040,979**	**3,949,203**	**12,152,139**	**2,835,967**	**148,766**	**1,222,640**	**22,349,694**
Additions	**25,356**	**350,074**	**104,022**	**319,714**	**1,351**	**108,523**	**909,040**
Disposals	**(116,371)**	**(356,744)**	**(36,363)**	**(140,560)**	**(39,433)**	**(104,356)**	**(793,827)**
Balance at December 31, 2006	**1,949,964**	**3,942,533**	**12,219,798**	**3,015,121**	**110,684**	**1,226,807**	**22,464,907**
Depreciation and losses from impairment							
Balance at January 1, 2005	1,310,170	4,407,230	9,208,007	1,624,298	135,667	804,215	17,489,587
Depreciation for the year	96,275	746,227	300,708	366,484	19,248	137,362	1,666,304
Cancellation in respect of disposals (d)	(2,010)	(3,791,216)	(24,625)	(122,242)	(39,789)	(72,812)	(4,052,694)
Balance at December 31, 2005	1,404,435	1,362,241	9,484,090	1,868,540	115,126	868,765	15,103,197
Balance at January 1, 2006	**1,404,435**	**1,362,241**	**9,484,090**	**1,868,540**	**115,126**	**868,765**	**15,103,197**
Depreciation for the year	**104,456**	**693,354**	**276,764**	**372,881**	**13,450**	**130,149**	**1,591,054**
Cancellation in respect of disposals	**(83,824)**	**(353,604)**	**(36,363)**	**(110,263)**	**(35,036)**	**(102,616)**	**(721,706)**
Balance at December 31, 2006	**1,425,067**	**1,701,991**	**9,724,491**	**2,131,158**	**93,540**	**896,298**	**15,972,545**
Net carrying value							
At January 1, 2005	686,869	2,759,705	2,799,624	922,868	55,068	340,170	7,564,304
At December 31, 2005	636,544	2,586,962	2,668,049	967,427	33,640	353,875	7,246,497
At December 31, 2006	**524,897**	**2,240,542**	**2,495,307**	**883,963**	**17,144**	**330,509**	**6,492,362**

NOTE 9 – PROPERTY, PLANT AND EQUIPMENT (CONTD.)

A. COMPOSITION AND MOVEMENT (CONTD.)

a. Determination of fair value as deemed cost – Certain items of property, plant and equipment from the switching, transmission and power group of equipment, principally switching equipment, which were revalued to fair value on the date of transition to the IFRS, were measured on the basis of their deemed cost, which was determined according to their fair value on the transition date (January 1, 2005), as assessed by the Group based on valuation an external appraiser. See Note 33(a).

b. Residual value – The residual value of the Group's copper cables as assessed at the end of the reporting year. The residual value is approximately NIS 409 million and NIS 598 million at December 31, 2005 and December 31, 2006 respectively.

c. Cost of dismantling and removal of assets – The cost of items of property, plant and equipment includes dismantling and removal costs, as well as other restoration costs to which the Group has an obligation. These costs are depreciated according to the expected useful life of the sites. Capitalisation of the costs of property, plant and equipment and the calculation of the accumulated depreciation at January 1, 2005 (the date of transition to the IFRS) are shown in Note 33. During 2006, the Group capitalised approximately NIS 1,210 thousand costs for dismantling and removal of assets (2005 – NIS 2,442 thousand).

d. Property, plant and equipment in the Group is disposed of at the year end upon reaching full depreciation, except for land, buildings and vehicles, which are disposed of on their sale. In 2006, the Group disposed of fully depreciated property at a cost of approximately NIS 565 million (2005 – NIS 3,996 million). .

e. The cost includes NIS 1,207 thousand in the Group, representing real financing expenses, which were capitalised in the statement period in respect of loans and credit in the construction period calculated at a real average interest rate of approximately 4.3% per year (prior year – 4.8%).

f. On December 31, 2006, Pelephone has a commitment to purchase terminal equipment during 2007, for a total amount of NIS 272 million.

g. At the balance sheet date, there are agreements to purchase property, plant and equipment totalling approximately NIS 608 million (the amounts include the remarks in sub-section f. above).

h. Concerning liens, see Note 19.

NOTE 10 – INTANGIBLE ASSETS

	Goodwill	Computer software and licenses and discounted development costs	Subscriber acquisition, net	Right of use of frequencies	Others	Total
	NIS thousands					
Cost						
Balance at January 1, 2005	1,792,658	1,025,947	173,593	220,104	49,243	3,261,545
Developed by the Group or purchased separately	-	147,670	52,192	-	82	199,944
Balance at December 31, 2005	1,792,658	1,173,617	225,785	220,104	49,325	3,461,489
Balance at January 1, 2006	1,792,658	1,173,617	225,785	220,104	49,325	3,461,489
Acquisitions in business combinations	**83**	**-**	**-**	**-**	**-**	**83**
Developed or purchased separately by the Group	**-**	**147,306**	**49,064**	**-**	**177**	**196,547**
Balance at December 31, 2006	**1,792,741**	**1,320,923**	**274,849**	**220,104**	**49,502**	**3,658,119**
Reductions and losses from impairment						
Balance at January 1, 2005	-	470,953	121,144	-	17,248	609,345
Amortisation for the year	-	176,426	59,910	-	4,774	241,110
Balance at December 31, 2005	-	647,379	181,054	-	22,022	850,455
Balance at January 1, 2006	**-**	647,379	181,054	-	22,022	850,455
Amortisation for the year	**-**	**200,171**	**44,856**	**-**	**2,530**	**247,557**
Loss from impairment	**5,865**	**-**		**-**		**5,865**
Balance at December 31, 2006	**5,865**	**847,550**	**225,910**	**-**	**24,552**	**1,103,877**
Net carrying value –						
At January 1, 2005	1,792,658	554,994	52,449	220,104	31,995	2,652,200
At December 31, 2005	1,792,658	526,238	44,731	220,104	27,303	2,611,034
At December 31, 2006	**1,786,876**	**473,373**	**48,939**	**220,104**	**24,950**	**2,554,242**

NOTE 10 – INTANGIBLE ASSETS (CONTD.)

Total value of goodwill allocated to each unit is as follows:

	2006 NIS thousands	2005 NIS thousands
Pelephone Communications Ltd. (1)	**1,026,696**	1,026,696
D.B.S. Satellite Services (1998) Ltd. (2)	**760,097**	760,097
Others	**83**	5,865
	1,786,876	1,792,658

(1) The value of the holding in Pelephone was calculated by the Discount Cash Flow (DCF) method, and was based on the following assumptions:

A detailed projected cash flow for 5 years, which is a reasonable assessment range for which a detailed cash flow can be prepared.

- An income forecast was constructed on the basis of a forecast for the number of subscribers and average revenue per user (ARPU) according to the structure of revenues from departments plus revenues from sales of handsets. The subscriber forecast is based on a cellular company market model, taking into account market saturation, population growth, and assuming an increase of 1% - 1.3% in Pelephone's market share in the forecast periods.
- The ARPU forecast is based on the following: a decrease in call minutes compared with the average in 2005 (in the forecast for 2006). Following a significant decline in call minutes in 2006, a rise in call minutes was assumed for 2007, a rise in prices is expected in the first year of the forecast, a reduction in interconnect prices, and an increase in revenues from value added services.
- The operating and the sales and marketing expenses were adjusted for the anticipated volume of operations. Tax was deducted from the profit at the statutory tax rate in each year.
- Investments were taken according to Pelephone's investment plan, which consists mainly of the set-up and deployment of third generation sites, set-up of the HSUPA network, investment in IT and in subscriber acquisition.
- The capitalisation rate taken, 9.5% and 9.6% for 2005 and 2006 respectively , was calculated by the WACC model and based on a capital price of 11.5% and 12% respectively, and a debt price of approximately 6.75%.
- Beyond the fifth year, growth of about 1% was assumed, taking into account population growth, the stabilization of the market among the cellular companies, and the competition possible future and alternatives.

The value obtained from these assumptions is highly sensitive to the following:

- An increase of one half of one percent in the capitalisation rate reduces the value by approximately 7.5%.
- A decrease of one percent in ARPU in the first year, decreases the value by 6.5%, and by 8% in 2006 and 2005 respectively.

As an additional indicator, the value of the holding in Pelephone was tested by the comparison with similar companies. Using this method, EV/EBITDA multipliers (enterprise value / earnings before tax, depreciation and amortization) were compared. The value obtained by this method is higher than the value obtained using the DCF method.

(2) The value of the holdings of DBS was calculated by the discounted cash flow method (DCF), and was based on the following data:

- A detailed projected cash flow was prepared for 10 years, the period in which the multi-channel television market is expected to stabilize.
- Transition to the tenth year assumed growth of approximately 1.8%, taking into account the growth in population, the balance between DBS and the cables, as well as competition and possible future alternatives.
- The income forecast was prepared on the basis of projected number of subscribers and average revenue per user (ARPU) which provide the revenue from the services. The subscriber forecast is based on the business plan of DBS for the coming year and on continued growth based on the growth forecasts for households in Israel, the customer churn rate based on past experience, global trends, and a forecast of the stabilization of competition and lower churn rates, where it was assumed that the market share of DBS would increase over the years at the expense of the cable companies, to about 40% (compared with 33% today).
- The ARPU is based on a price rise implemented during 2006, and on future price rises of approximately 2% per year, based on adding value-added services while taking into consideration competition and the weight of the expense in the total household expense.

NOTE 10 – INTANGIBLE ASSETS (CONTD.)

- The operating and the sales and marketing expenses were adjusted for the anticipated volume of operation, while assuming that the content expenses, which are DBS's principal expense item, would be about 33% of income from 2008 onwards.
- DBS has considerable losses for tax purposes. Accordingly, tax was not taken in the forecast period. After the forecast period, tax was taken at 25%, in respect of the part of the profit exceeding the cumulative loss at that date.
- Investments are mainly in installations, and in decoders which are a function of new subscribers, net, and the accepted level of decoder replacement, based on past data. In addition, engineering investments for preserving what is and developing new areas.
- The capitalisation rate taken, 13% -13.5%, takes into account DBS's dependence on external financing, limitations and dependence on changes in regulation, and the equity structure of DBS.
- The calculated value was attributed initially to the new shareholder loans (which were provide after July 2002) of about one billion shekels, since under the agreement they will be paid before the old loans. The Company's part in the loans is approximately 85%. The balance was attributed to repayment of the shareholder loans, in which the Company's part is approximately 51%.

The value calculated with the above assumptions is highly sensitive to the following:

- An increase of one half of one percent in the capitalisation rate taken will reduce the value by 7% (2006) to 15% (2005).
- A decrease of one percent in the ARPU in the first year, reduced the value by 4% (2006) to 11% (2005).

NOTE 11 – DEFERRED AND OTHER EXPENSES

	2006	2005
	NIS thousands	NIS thousands
Land lease rights (1)	**220,734**	230,301
Long-term prepaid expenses in respect of use of capacities (2)	**146,775**	154,249
Long-term prepaid expenses in respect of lease agreement	**6,240**	7,188
	373,749	391,738

(1) Most of the real estate assets used by the Company were transferred to it by the State of Israel pursuant to and at the consideration stated in an agreement from January 31, 1984. Some of these assets are leased for 49 years, with an option to extent for another 49 years, and some are rented for two years, renewable each time for another two years.
On May 15, 2003, the Company signed a settlement agreement with the Government of Israel on behalf of the State, and Israel Lands Administration, regulating the dispute between them in the matter of the Company's rights in various real estate assets which were transferred to the Company when it commenced operation in 1984 under the asset transfer agreement signed between the Company and the State.
The rights are amortized over the course of the lease period.

(2) See Note 3H.

NOTE 12 – INVESTEES ACCOUNTED FOR BY THE EQUITY METHOD

A. Below are condensed financial data regarding a principal investee company accounted for by the equity method, without adjustment for percentage ownership held by the Group.

	Rate of ownership	Current assets	Non-current assets	Total assets	Current liabilities	Non-current liabilities	Total liabilities	Income	Profit/loss
		NIS thousands							
2005									
Walla! Communications Ltd.	42.85%	37,471	12,906	50,377	16,070	7,661	23,731	75,644	10,649
2006									
Walla! Communications Ltd.	44.04%	**66,639**	**25,360**	**91,999**	**26,515**	**4,163**	**30,678**	**100,977**	**25,242**

NOTE 12 – INVESTEES ACCOUNTED FOR BY THE EQUITY METHOD (CONTD.)

B. The investment in an associate company comprises the investment of a consolidated subsidiary in Walla! Communications ("Walla") (an associate), an Israeli company whose shares are listed on the stock exchange in Tel Aviv and whose business is the provision of internet services and the operation of portals to the internet.

Composition of the investment

	December 31 2006	December 31 2005
	NIS thousands	NIS thousands
Cost of shares (1)	**79,615**	74,504
Exercisable option warrants	**102**	615
Share in equity reserve in respect of financial assets classified as available for sale	**707**	688
Share in accumulated losses, net	**(28,066)**	(39,845)
	52,358	35,962
Index-linked interest-free loans (2)	**872**	5,514
	53,230	41,476
Deductions in respect of impairment (1)	**(21,108)**	(21,108)
	32,122	20,368

(1) The balance at December 31, 2006 and 2005 includes goodwill, the cost of which at those dates amounts to NIS 46,132 thousand and NIS 44,199 thousand respectively, and the net book value at the same dates amounts to NIS 6,584 thousand and NIS 4,374 thousand, respectively.

(2) During 2006 and 2005, Bezeq International exercised, as did others, option warrants of Walla (series 3). In all, Bezeq International exercised 2,564,764 and 213,397 option warrants (series 3) in 2006 and 2005 respectively, in consideration of NIS 4,617 thousand and NIS 384 thousand respectively, which were offset against the balance of the shareholder loans which Bezeq International provided to Walla. Following exercise of the options warrants, Bezeq International recognised a surplus cost of NIS 2,313 thousand and NIS 154 thousand in 2006 and 2005, respectively. In accordance with the provisions of IFRS 3, the cost of the purchase was attributed to the fair value of intangible assets, based on the Purchase Price Allocation (PPA) made by an external appraiser.
At December 31, 2006, Bezeq International holds 44.04% of the rights in Walla (at full dilution – 33.66%).
After the balance sheet date and by the date of publication of the financial report, Bezeq International's holding in Walla decreased to approximately 42.57% (at full dilution – 33.66%), as a result of additional option warrants (series 3) exercised by others.
At December 31, 2006 Bezeq International held 44.04% of the rights in Walla (fully diluted – 33.66%).
Subsequent to the balance sheet date and through the date of publication of these financial statements the percentage holding of Bezeq International in Walla was reduced to 42.57% (fully diluted (33.66%), this being the result of additional exercises of the options warrants (Series 3) by others.

(3) The market value of Bezeq International's holding in Walla shares at December 31, 2006 is NIS 122.6 million, and the market value of the option warrants (series 3) is approximately NIS 3.2 million (2005 – market value of shares approximately NIS 75.6 million and option warrants approximately NIS 12.7 million).

NOTE 12 – ASSOCIATES ACCOUNTED FOR UNDER THE EQUITY METHOD (CONTD.)

C. Movement in investments in 2006 is as follows:

	NIS thousands
Balance at the beginning of the year	**20,368**
Movement during the year:	
Investment in shares	**5,111**
Repayment of loans, net	**(4,642)**
Group's equity in investee company's earnings	**11,184**
Groups share in profit from decrease in holding	**595**
Decrease in exercisable option warrants	**(513)**
Increase in share in equity reserve in respect of financial assets classified as available for sale	**19**
Balance at the end of the year	**32,122**

NOTE 13 – LOANS AND BORROWINGS

This Note provides information about the contractual terms of the interest-bearing loans and borrowings. For more information about the exposure of the Group to interest rate and foreign currency risks, see Note 30.

A. Composition

	Consolidated	
	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Current liabilities to banks		
Short-term borrowings	**118,330**	75,184
Current maturities of debentures	**1,992,640**	526,709
Current maturities of bank loans	**1,526,377**	2,558,759
	3,637,347	3,160,652
Non-current liabilities to banks and others		
Debentures	**3,169,441**	4,891,340
Bank loans	**480,830**	748,053
Loans from institutional entities (see C below)	**169,182**	107,732
	3,819,453	5,747,125
	7,456,800	8,907,777
Loans provided by the minority in a consolidated company	**564,250**	505,280

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

B. Terms and debt repayment table

	Currency	Nominal interest rate %	Redemption year	December 31, 2006 Par value	December 31, 2006 Carrying value	December 31, 2005 Par value	December 31, 2005 Carrying value
				NIS thousands			
Short-term borrowings	Shekel	Prime + (0.5)-1.2	2007	**118,330**	**118,330**	75,184	75,184
Loans from banks and others:							
In foreign currency	Dollar	LIBOR + (0.65-0.45)	2006	**-**	**-**	517,563	563,867
Linked to the consumer price index	Shekel	11.0-3.9	2007-2015	**1,485,852**	**1,5 28,390**	1,820,865	1,878,202
In foreign currency	Dollar/shekel	4.36-3.67	2006	**-**	**-**	230,150	230,150
Unlinked	Shekel	Prime + (1.15-1.2)	2007-2013	**647,999**	**647,999**	742,235	742,325
					2,294,719		3,489,728
Debentures issued to the public:							
Linked to the consumer price index (series 4 and 5) (1)	Shekel	4.8-5.3	2008-2016	**1,636,967**	**1,704,322**	1,636,967	1,714,244
In foreign currency (2)	Euro	6.5	2007	**1,630,340**	**1,628,733**	1,595,825	1,591,647
Unlinked	Shekel	Bank of Israel Interest + 0.5	2006	**-**	**-**	36,443	36,423
					3,333,055		3,342,314
Debentures issued to financial and other institutions:							
Linked to the consumer price index	Shekel	4.4-6.35	2007-2015	**1,726,497**	**1,798,647**	1,930,513	2,045,999
Linked to the euro	Shekel	LIBOR + 0.8	2008	**22,000**	**30,379**	22,000	29,736
					1,829,026		2,075,735
Total interest-bearing liabilities					**7,456,800**		8,907,777
Loans provided by the minority in a consolidated company	Dollar	0-11	2013	**1,009,902**	**564,250**	1,100,255	505,280

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

B. Terms and debt repayment table (contd.)

(1) The balance of the par value of the debentures is NIS 3,586,967,000, of which NIS 1,636,967,000 par value were issued to the public.

a. The balance of the par value of the debentures (series 4) is 1,200,000,000 of NIS 1 par value each, repayable in 4 equal annual instalments in each of the years 2008 – 2011. The interest rate determined for these debentures in 4.8% p.a.

b. The balance of the par value of the debentures (series 5) is 2,386,867,000 of NIS 1 par value each, of which 436,967,000 debentures were issued to the public and to institutional investors, and the balance of 1,950,000,000 to Bezeq Zahav Holdings Ltd. (wholly controlled by the Company). The debentures are payable in 6 equal annual instalments in each of the years 2011-2016. The interest rate determined for these debentures is 5.3%.

The debentures were registered on the stock exchange and trading in a portion of them will be subject to the lock-up limitations prescribed in the Securities Law

(2) The balance of the par value of the debentures held by the public is 293,000,000 euro.

C. (1) In March and April 2005, DBS signed agreements with three institutional entities, whereby those entities would provide loans to DBS in a total amount of NIS 50 million.

The three institutional entities were granted an option to provide additional loans in the same amount, provided that the amounts of the loans are required by the business plan of DBS. During 2005, the three institutional entities exercised the above option, and provided DBS with additional loans amounting to NIS 50 million.

The Company undertook, in connection with the aforementioned loans, that if by December 31, 2013 the loans (all or some of them) were not repaid or upon fulfilment of certain other conditions, the lenders could demand that it repay the lower of the balance of the loans (principal, interest and linkage) and an amount computed according to a formula which was determined, which takes into account the value of DBS at that date. In view of the Company's undertaking, on June 22, 2005 the Company received a letter from the Director General of the Ministry of Communications, giving notice of the decision of the Ministry to call in a guarantee in the amount of NIS 10 million out of the bank guarantee the Company had provided in accordance with the provisions of its general license. According to the Director General's notice, the decision to call in the guarantee was made in view of the fact that the Company had made a commitment to the institutional entities in a manner which contravenes the directive of the Minister of Communications. The Company's position is that there is no legal or other basis for forfeiture the guarantee. An appeal against the decision was submitted to the Minister of Communications, and in the meantime, implementation of the forfeiture is frozen (see also Note 32(3)).

(2) In December 2006, DBS signed an agreement with another institutional entity for receipt of a loan of NIS 50 million.

DBS was granted an option for an additional loan in the same amount. Under the agreement, if DBS takes additional financing not for which does not represent the rolling over of the existing loans and as result of taking it, DBS's total debt does not comply with a certain EBITDA limitation defined in the loan agreement, then the interest rate on the loan from the institutional entity will change to 9%. DBS intends to exercise an option for an additional loan of NIS 50 million from the same institutional entity.

(3) The balance of the loans from institutional entities at December 31, 2006 includes accrued interest of NIS 17,353 thousand (2005 – NIS 5,605 thousand).

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

D. Charges and collateral

(1) The debentures of the Company, whose book amount at December 31, 2006 is NIS 4,176,079,000 (net of deferred expenses), are not secured except for a symbolic charge, but the Company under took that as long as the debentures are in circulation, it will not encumber its property with other charges.

The lenders have a right to call for immediate payment of the debentures in cases where the Company does not pay the debentures or violates their terms, if a significant attachment is imposed on its assets (which is not lifted within 60 days), if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to run its business, or if the holder of another charge realises the charge it has on the assets of the Company.

In addition, some of the lenders, from whom the balance of the debentures at December 31, 2006 amounts to NIS 228,917,000, may call for immediate payment of the debentures due to a decrease in the State's holdings in the share capital of the Company to less than 26%. For this reason, the balance in the financial statements is shown as a short-term liability.

In addition, for a balance of NIS 1,628,733,000 (net of deferred expenses) of debentures listed on the stock exchange in Luxembourg, which were issued to the public in euro, upon the occurrence of an event enabling other loans of the Company (except for such an event deriving from a decrease in the State's holdings in the Company) and of its material subsidiaries, as defined in the text of the debentures (Pelephone is the only company that matches the definition of a material subsidiary according to these debentures; it is noted that DBS is not considered a material subsidiary as defined in the debentures) to be called for immediate repayment, if the Company does not meet the payments determined in respect of the debentures, if the Company or its material subsidiaries cease to run their businesses or they enter receivership, liquidation or similar proceedings, and upon the occurrence of additional events of non-fulfilment of the undertakings of the Company and its material subsidiaries, as described there.

In connection with the Company's approach to the tax authorities for approval of an exemption from the withholding tax from interest paid in respect of these debentures, the Company reached agreement with the assessing officer whereby it would be exempt from withholding the tax from August 1, 2004 until final payment of the debentures. It was also agreed that if the debt-equity ratio at the Company is higher than 1:1.5, the Company's financing expenses would be adjusted in the tax year, but not more than the amount of the financing expenses for the debentures. This arrangement will be examined in the quarterly statements of the Company and applied each quarter. On this matter, "debt" – any interest-bearing liability or linkage differentials, the value of which varies as a result of changes in the interest rate or the linkage differentials, except for a liability to employees or former employees.

The Company's position is that at the balance sheet date, the Company is in compliance with these terms.

The Company created a negative pledge in favour of the aforementioned debenture-holders.

(2) a. The bank loans and debentures ("credit providers") of Pelephone, the carrying amount of which at December 31, 2006 is NIS 1,320 million, are secured by an irrevocable liability in favour of the credit providers, whereby Pelephone created a negative pledge to their credit.

The liability includes, *inter alia*:

(1) A declaration that Pelephone will not encumber its assets (as may be from time to time), in whole or in part, in any manner and by means of a floating lien or a fixed lien of any type or rank, in favour of any third party, without the prior written consent of the credit providers.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

D. Charges and collateral (Contd.)

(2) (Contd.)

(2) Compliance with the following financial stipulations:
a. An undertaking that Pelephone's debt will not exceed three times its shareholders' equity and an undertaking that as long as that ratio exceeds 2.5, dividends will not be distributed and management fees will not be paid to the shareholders.
b. Pelephone undertook that the amount of its debts will not exceed NIS 3.8 billion (linked to the known Index in January 2002).
c. An undertaking towards a certain bank that its total debt to it will not exceed 40% of its total debts to all the financial entities.

At the date of the financial statements, Pelephone is in compliance with its undertakings and the financial stipulations with which it undertook to comply for the banks.

b. Under its general license for cellular services, Pelephone is not permitted to sell, lease or pledge any of its assets used for performance of the license, without the consent of the Minister of Communications, except –

(1) charge of one of the license assets in favour of a bank operating lawfully in Israel, for receipt of bank credit, provided that it submitted notice to the Ministry of Communications concerning the charge it intends to register, noting that the charge agreement includes a clause ensuring that in any case, exercise of the rights by the bank will not harm in any way the provision of the services pursuant to the license;

(2) the sale of items of equipment when implementing an upgrade proceeding, including sale of equipment by the trade-in method.

(3) The terms of long-term loans which DBS received from banks, the balance of which at December 31, 2006 is NIS 1,394 million, impose restrictions with regard to the encumbrance or sale of certain assets of DBS: a restriction on receipt of credit from banks and others (without the approval of the lending bank), a restriction on the distribution of a dividend, a restriction with regard to repayment of shareholder loans and restrictions on transactions with interested parties, a restriction on changes in the percentage of shareholders' holdings, a restriction relating to DBS's compliance with the various licenses granted to it, a restriction related to the purchase of securities by DBS and the establishment of a subsidiary, restrictions relating to the allocation of shares or other securities of DBS.

In addition, the terms of the loans impose various restrictions, including a demand to comply with the following financial covenants:

a. Minimum total income.
b. Minimum operating surplus (as defined in the financing agreement).
c. Minimum operating surplus less investment in decoders (as defined in the financing agreement).
d. Maximum churn rate.
e. Total financing needs (as defined in the financing agreement).
f. Maximum supplier credit.
g. Minimum cover of bank debt and debt balances (as defined in the financing agreement).

The values for compliance with the financial criteria vary, and are measured each quarter. Non-compliance with the financial criteria grants the banks a right to demand early repayment of the loans DBS received.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

D. Charges and collateral (Contd.)

(3) (contd.)

At December 31, 2006, DBS is in compliance with the above terms (after a relief granted it in December 2006), but DBS's Management does not expect that DBS will comply with the terms in 2007 and thereafter. In view of this forecast, the bank loans are presented as part of short-term liabilities.

In light of the forecast of DBS's Management for its business results in 2007, DBS approached the banks for planning and adjusting the dates for full repayment of the bank credit. At the date of approval of the financial statements, these terms are not yet finalised. The Management of DBS is also negotiating with the banks for settlement of a dispute relating to insurance obligations set out in the financing agreement.

To secure these liabilities (and guarantees of NIS 40 million), DBS registered a charge on all its assets, including shareholders' equity and goodwill.

E. Debenture issue expenses

The expenses for issuing the debentures amounted to approximately NIS 22 million for 2006 and 2005, and are presented after deduction of accumulated amortisation of NIS 14,328 thousand (2005 – NIS 11,938 thousand).

NOTE 14 – TRADE AND OTHER PAYABLES, INCLUDING DERIVATIVES

	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Trade payables		
Open debts	**1, 221,288**	1, 272,253
Notes payable	**84,399**	161,821
Trade payables due to related and interested parties	**87,881**	111,036
Other trade payables	**–**	3,347
Total trade payables	**1,393,568**	1,548,457
Other payables, including derivatives		
Government of Israel in respect of royalties	**65,411**	80,212
Liabilities to employees and other liabilities for salary	**298,101**	823,955
Government institutions	**105,032**	128,191
Liabilities to related parties and interested parties	**49,067**	42,168
Accrued interest	**135,606**	150,704
Derivatives	**27,525**	75,657
Payables and other credit balances	**122,005**	96,109
Total other payables, including derivatives	**802,747**	856,996
	2,196,315	2,405,453

Amounts payable denominated in a currency other than the functional currency include approximately NIS 380,967 thousand in respect of suppliers denominated in US dollars (2005 – NIS 504,866 thousand), and approximately NIS 95,242 thousand in respect of suppliers denominated in euro (2005 – NIS 126,838 thousand).

NOTE 15 – PROVISIONS

	Legal claims and other disputes	Employee compensation claims	Dismantling and clearing of sites	Onerous contracts	Warranty and others	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance at January 1, 2006	206,331	50,469	43,225	9,135	3,010	312,170
Provisions created during the period	**49,102**	**55,000**	**1,210**	**–**	**7,700**	**113,012**
Provisions used during the period	**–**	**–**	**(2,150)**	**(953)**	**–**	**(3,103)**
Provisions cancelled during the period	**(84,699)**	**–**	**–**	**(388)**	**–**	**(85,087)**
Effect of the elapse of time in respect of capitalisation	**1,938**	**–**	**1,833**	**(55)**	**–**	**3,716**
Balance at December 31, 2006	**172,672**	**105,469**	**44,118**	**7,739**	**10,710**	**340,708**
Current	172,672	105,469	–	–	10,710	288,851
Non-current	–	–	44,118	7,739	–	51,857
	172,672	105,469	44,118	7,739	10,710	340,708

Legal claims
For salary claims filed against the Group and legal claims and other disputes, see also Note 17.

Dismantling and clearing of sites
The provision in respect of the debts of a consolidated company for clearing sites it leases.

Onerous contracts
A consolidated company entered into agreements granting it usage rights in transmission equipment (an old generation of sea-bed cables), for periods ending between 2016 and 2024. Under these agreements, the subsidiary is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of the cables. The Management of the consolidated company believes that the unavoidable costs of compliance with these agreements exceed the economic benefits expected to accrue from use the cables. This assessment, together with Management's decision not to operate the sea-bed cables, was the rationale for making a provision in the financial statements. The balance of the provision reflects the discounted value of all the unavoidable costs which the subsidiary must pay to the owner of the cables until the end of the term of the agreements.

NOTE 16 – EMPLOYEE BENEFITS

A. Composition

	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Present value of unfunded obligations	**245,317**	139,649
Present value of funded obligations	**196,544**	174,891
Total present value of obligations	**441,861**	314,540
Fair value of the plan assets	**(130,236)**	(113,650)
	311,625	200,890
Past service cost – non vested benefit	**(72,936)**	-
Recognised liability in respect of a defined benefit plan	**238,689**	200,890
Liability for vacation	**95,595**	84,980
Liability for sickness	**65,429**	55,955
Liability for voluntary early retirement	**879,526**	772,251
Total employee benefits	**1,279,239**	1,114,076
Stated in the balance sheet as follows:		
Short-term	**906,203**	717,723
Long-term	**373,036**	396,353
	1,279,239	1,114,076

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

A. Composition (Contd.)

	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Movement in a liability in respect of a defined benefit plan		
Liability in respect of a defined benefit plan at January 1	**314,540**	276,602
Benefits paid according to the plans	**(20,468)**	(14,626)
Current service cost and interest (see below)	**46,282**	36,546
Past service cost– non vested benefit	**72,936**	-
Past service cost - vested benefit	**31,799**	-
Actuarial (gains) losses recognised in equity (see below)	**(3,228)**	16,018
Liability in respect of a defined benefit plan at December 31	**441,861**	314,540
Movement in the assets of the plan		
Fair value of the assets of the plan at January 1	**11 3,650**	96,528
Amounts deposited in the plan	**21,538**	16,339
Benefits paid	**(9,030)**	(4,116)
Expected return on plan assets	**3,879**	4,092
Actuarial gains (losses) recognised in equity (see below)	**199**	807
Fair value of the assets of the plan at December 31	**130,236**	113,650
Expense recognised in the income statement		
Current service cost	**34,304**	23,031
Interest on the obligation	**11,978**	13,515
Expected return on the assets of the plan	**(3,880)**	(4,092)
Past service cost - vested benefit	**31,799**	-
	74,201	32,454
The expense was included in the following items in the income statement		
Salary expenses	**66,501**	24,020
Financing expenses	**7,700**	8,434
	74,201	32,454
Actual return on the plan assets	**2,629**	6,584
Actuarial gains and losses recognised directly in equity		
Amount accrued at January 1	**15,211**	-
Amounts recognised during the period	**(3,427)**	15,211
Amount accrued at December 31	**11,784**	15,211

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

B. Actuarial assumptions

The principle actuarial assumptions at the date of the report:

1. Mortality rates are based on the rates published in Insurance Circular 3-1-2007 of the Ministry of Finance, except for early retirement, which was calculated using pension table 2000/1, and including future improvements in the mortality rate.

2. Leaving rates were determined on the basis of the past experience of the Company and the subsidiaries, distinguishing between employees entitled to supplementary compensation and those who are not, depending on the number of years of employment in addition to the above distinction made. In the company – the leaving rate is determined, additionally, with a distinction made between permanent employees (between 3.5% in the first year to 0.5% over 10 years'), personal contract employees (5.5% per year), senior employees (20% per year), and temporary employees (34% in the first year to 25% over 7 years).
Bezeq International – The leaving rate includes a distinction made between headquarters employees with compensation (between 2.2% for the first year up to 4% over 11 years), headquarters employees without compensation (between 17.6% for the first year to 2% from the seventh year onwards), non-headquarters' employees with compensation (3.3% in the first year to 4% over 11 years), headquarters employees without compensation (48.1% in the first year to 3% over 6 years). Pelephone – The leaving rate includes a distinction made between senior employees with compensation (8% per year), senior employees without compensation (12% for the first year and 2.5% over 11 years), non-senior employees with compensation (5% for the first year and 25% from the second year), and non-senior employees without compensation (45% for the first year and 7% from the third year). DBS – The leaving rate for all employees (about 20% in the first year and up to 2% over 5 years).

3. The discounted rate is based on yield on government bonds at a fixed interest rate which have a lifetime equal to that of the gross liability.

	December 31, 2006	December 31, 2005
	Discounted rate	Discounted rate
Compensation	**3.7%**	3.7%
Sick leave	**3.6%**	3.8%
Vacation	**3.6%**	3.8%
Retirement benefit – holiday gift	**5.2%**	5.2%
Retirement benefit – clubs and activities	**3.6%**	3.8%
Early notice to senior employees	**3.6%**	-

4. Assumptions regarding salary increments were made on the basis of the Company's experience and Management's assessments, distinguishing between groups of employees as explained in sub-section 2 above over the period of their service to retirement. The rate of salary costs fluctuates mostly between 1% per year for older employees to 16% per year for younger employees.
The Company – For permanent employees and personal contract employees, the average salary increment is 6% per year at age 20, and from that age onwards the salary increment decreases linearly and stabilises at a rate of 1.75% at age 60. For senior employees the salary increment is 6% per year throughout their period of service. For temporary employees, the salary increment decreases by about 1% each year, and stabilises at an increment rate of about 1% from age 40 onwards. For non-headquarters employees, the salary increment rate was assumed to be an average of 1% per year.
Pelephone – For senior employees at age 21, salary costs of 4% increases linearly to 14% at age 28, and from that age onwards, decreases linearly to 2.5% at age 39. For non-senior employees from age 21 to age 28 a salary increment of 16%, and from that age a linear decrease to 2.5% at age 39.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

B. Actuarial assumptions (Contd.)

DBS – For all employees, the salary increment rate is 5% per year throughout the period of service.

5. The growth rate foreseen in the assets accumulated in all the companies in the Group except those of the Company, is 3% per year – a rate reflecting an expected value return of 4% and less 1% management fees, while in the Company, the growth rate in accumulated assets is only 2%. This rate reflects the fact that most of the funds are in old pension funds in which the yield rate is fixed.

C.

	December 31, 2006	December 31, 2005	January 1, 2005
	NIS thousands	NIS thousands	NIS thousands
Present value of liability in respect of a defined plan	**441,861**	314,540	276,602
Fair value of the plan assets	**(130,236)**	(113,650)	(96,528)
Plan deficit	**311,625**	200,890	180,074
Adjustments for assets arising from prior experience	**3,987**	11,577	
Adjustments for liabilities arising from prior experience	**(3,579)**	77	

In 2007, the Group expects to pay NIS 19,520 thousand as a deposit in a defined benefit plan.

D. Defined deposit plans

1. The pension rights of Company employees in respect of the period of their employment in the civil service through January 31, 1985, are covered by a pension fund ("Makefet Fund"), which took upon itself the State's commitment following an agreement between the Government of Israel, the Company, and Histadrut and the Fund.

2. Liabilities for employee benefits at retirement age in respect of the period of their service in the Company and in the investee companies, are covered in full by regular payments to pensions funds and insurance companies.

3. The severance pay liability for those who leave their employment on terms entitling them to compensation, is covered, for the period from February 1, 1985. by regular deposits in pension funds and insurance companies as aforesaid (in accordance with Section 14 of the Severance Pay Law). Severance pay in respect of the period of employment in the civil service up to January 31, 1985, is actually paid by the Company, and the monies accumulated in Makefet Fund in respect of that period is maintained in a fund that will be used for the employees' rights. For a small number of the employees (employed under special contracts), the Company has a liability to pay them severance pay in excess of the amount accumulated in the compensation fund in the employees' name.

E. Defined benefit plan

1. The severance liability include in the balance sheet represents the balance of liabilities not covered by deposits and/or insurance policies in accordance with the existing labour agreements, the Severance Pay Law, and the salary components which the Managements of the companies believe entitle the employees to receipt of compensation. In respect of this part of the liability, there is a reserve deposited in the Company's name in a recognised compensation fund. The reserves in compensation funds include accrued linkage differentials and interest accrued and deposited in compensation funds in banks and insurance companies. Withdrawal of the reserve monies is contingent upon fulfilment of detailed provisions in the Severance Pay Law.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

E. Defined benefit plan (Contd.)

2. The new collective agreement from December 5, 2006, provides, among others, that employees who transferred from the civil service to the Company, who end their employment due to retirement after December 31, 2013, are entitled to a supplement to close the gap between the two Civil Service Law tracks and the regulations governing Makefet.
   As a result of this clause in the agreement, the benefit to these employees is enhanced. The Company includes in its financial statements the liability net of the cost of prior service not yet vested. This benefit will be spread on a straight line basis over a period of 18.75 years (the average period to vesting of the benefit).

3. Through December 2006, liability in respect of early notice for senior employees was not included in the financial statements. In September 2006, the Company's Management decided that this benefit should be paid upon severance. Accordingly, the liability is included in the financial statements in accordance with the employment agreement and an actuarial calculation. The increase in the benefit in respect of this change is recorded as cost of prior service vested immediately, and is therefore recognised immediately in profit and loss.

4. Company retirees receive, in addition to the pension payments, benefits which consist mainly of a holiday gift, financing of the maintenance of retiree clubs and of social activities. The Company's liability in respect of these costs accumulates during the service period. The Company includes in its financial statements the expected costs in respect of the post-employment period, based on an actuarial calculation for existing retirees and for the serving employees entitled to this benefit according to retirement age. The actuarial assumptions include those noted in section B above, and another assumption relating to this section – that there is no real increase in the benefits in accordance with Company policy. (It is noted that in practice, the holiday gift benefit is linked to the dollar exchange rate.)

F. Other long-term employee benefits

Provision for sick leave

The financial statements include a provision in respect of redemption and utilisation of sick leave for all Group employees and redemption of sick leave only for employees eligible under the terms of the employment agreement and the collective agreement from December 5, 2006. The provision was calculated on the basis of actuarial calculations. The actuarial assumptions include those noted in section B above, as well as assumption in connection with this section based on the Company's experience according to positive accumulation of days by most of the employees, utilisation of days by the LIFO method.

Provision for vacation

The financial statements include the provision for redemption and utilisation of vacation on the basis of an actuarial calculation. The actuarial assumptions include those noted in section B above, as well as assumptions in connection with this section, positive accumulation of days by most of the employees, utilisation of days by the LIFO method, and statistical tests for the amount of utilisation and the amount of redemption.

G. Benefits in respect of severance and voluntary retirement

A number of collective agreements concerning early retirement were signed in recent years. Below are details of the relevant agreements.

In September 2000, the Company reached an agreement with the Union to extend the early retirement collective agreement from 1997 ("the Retirement Agreement"). Under the Retirement Agreement, commencing April 1, 2001 and through December 31, 2006 (with an option to extend the date of final retirement for certain employees through December 31, 2008), another 1,770 employees will take early retirement, of whom 300 employees who are not transferred employees.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

G. Benefits in respect of severance and voluntary retirement (Contd.)

On April 17, 2005, a special collective agreement was signed between the Company and the Union and the Histadrut, enabling early retirement of employees through a substitute for Makefet Fund. On June 28, 2005, an agreement between the Company and Harel Insurance Co, Ltd. ("Harel") was completed and signed. The agreement regulates pension payments in respect of early retirement, as well as old age and survivor pension payment differences arising from legislative amendments to the Israel Economic Recovery Plan Law (Legislative amendments for attaining budget targets and the economic policy for the 2003 and 2004 financial years), 5763-2003, for employees who retired commencing at the end of 2003 and until the beginning of 2004, and/or who will retire from the Company in accordance with the special collective agreement for retirement signed in September 2000, as amended on March 18, 2004 ("the Retirement Agreement"). Following execution of the agreement with Harel, the aforementioned special collective agreement between the Company, the Union and the Histadrut was revised and amended on the same date (June 28, 2005)..
It is noted that all the approvals required were obtained, both for the agreement with Harel to come into force, and for the collective agreement from June 17, 2005 and its amendment to come into force, as signed between the Company and the Union and the Histadrut regarding regulation of the early retirement of the employees through Harel, as the substitute entity for Makefet, as noted above.

H. Other

(1) On December 3, 2006, the Board of Directors of the Company approved a new collective agreement between the Company and the Union and the Histadrut. The agreement regulates the labour relations in the Company following the transfer of control in the Company from the State of Israel, and delineates a new organisational structure for the Company. Below are the main points of the agreement:

a. All the agreements, arrangements and customs existing in the Company prior to execution of the agreement, including a mechanism for linking salaries to the public sector, will continue to apply only to the veteran permanent employees in the Company to whom the agreement applies, subject to changes inserted specifically in the present agreement. The hiring of existing and new temporary employees will be on the basis of monthly or hourly salary agreements based on a market salary model by occupation, with a high degree of managerial flexibility.

b. An organisational change was agreed upon, including on the basis, *inter alia*, of transition from a geographical structure to a functional structure, which will be implemented gradually over two years.

c. In 2006-2008, 975 permanent employees (325 in each of those years) will retire from the Company in early pension or increased compensation tracks. The quota of retirees includes the employees who were scheduled to retire in accordance with the previous early retirement agreements but have not yet done so. In addition, the Company may, at its discretion, terminate the service of another 1,225 permanent employees (245 permanent employees in one or more of the years 2009-2013). The terms of retirement that will be granted to retirees will be largely the same as the terms of retirement prevailing in the Company today.

d. On the subject of managerial flexibility and changes in existing agreements and arrangements, the Company may determine procedures and change them from time to time at its discretion (without derogating from the rights of employees under the collective agreements applicable to them). The Company has authority in all management matters, the organization, work arrangements, work processes, etc.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

H. Other (Contd.)

(1) (Contd.)

e. The Union declared that it would agree to and support the distribution of a dividend of NIS 1.8 billion to the shareholders which does not comply with the earnings test, which the Company intends to distribute with the approval of the court. The Company undertook that within 45 days of the date of completing the distribution, it would issue stock options to employees amounting to 3% of the Company's issued share capital (subject to increasing its registered capital and the approval of the authorised institutions of the Company), at an exercise price of 50% of the share price on the date of issue of the options. If issue of the options is not approved, the benefit will be awarded to the employees in cash. (See Note 26.)

f. In addition, the Company will pay the employees a special bonus for the period through December 31, 2006, in a total amount of NIS 44 million (out of this sum, the Company has paid NIS 40 million and will pay the additional NIS 4 million at a later date). Commencing in 2007, the bonus system customary in the Company (as a State-controlled company) would be changed in the manner detailed in the agreement.

g. The term of the agreement is from the date of its execution through December 31, 2011. The Company has an option to extend it for two additional years, through December 31, 2013. The term of the retirement section in the agreement (see section C above), will in any case be through December 31, 2013.

(2) Under the collective agreements applicable to labour relations in the Company, and in accordance with agreements with the Makefet Fund ("the Fund"), an option is reserved for Company employees, who are Transferred Employees, to retire under one of two retirement tracks. The method of calculation of the cost of the early retirement of the Transferred Employees was laid down in the provisions in a number of agreements and documents drawn up between the Company and the Fund between 1990 and 1996, including a letter of understanding prepared and signed by them in 1996. The Company contends that the Fund violated the provisions of the agreements in general, and those in the letter of understanding in particular, in that when making the calculations of early retirement costs for Transferred Employees, the Fund determined those data on the basis of the assumption that those employees had chosen the track in which the cost of acquisition is higher, while disregarding the track which those employees had actually chosen. According to an actuarial opinion prepared for the Company, the difference between the payments collected by the Fund from the Company according to its calculation, and the rate of those costs if made as contended by the Company, based on the retirement track actually chosen by the employees, is a cumulative nominal amount of more than NIS 128 million, the restitution of which the Company is claiming in a claim it filed against the Fund. On November 20, 2003, the Company filed another claim against the Fund for additional amounts, in respect of other components, amounting to approximately NIS 80 million. The Fund transferred data on the earlier retirees. Based on these data and on the previous file, a revised actuarial opinion was prepared, which quantified the total amount of the claim on the date of its filing at approximately NIS 280 million. The Fund filed defence documents in the court, in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company.

NOTE 17 – CONTINGENT LIABILITIES

During the normal course of business, legal claims were filed against the companies in the Group, including applications for certification as class action suits.

In the opinion of the managements of the Group's companies, which is based, *inter alia*, on legal opinions regarding the risks related to the claims, including the applications for certification of the class action suits, appropriate provisions have been included in the financial statements (Note 15), where such provisions were required, to cover the exposure resulting from such claims.

In the opinion of the managements of the Group's companies the additional exposure due to claims filed against the companies in the Group on various matters and in which the probability of realisation is remote or likely, amounts to approximately NIS 31 billion, of which approximately NIS 3.2 billion relates to salary claims filed by employees.

Concerning applications for certification as class action suits regarding which the Group has exposure beyond the aforesaid (since the claims do not state a specific amount), see claims in sections A(4), (5), (7) and (19) below.

Below are details of the status of the significant contingent liabilities of the Group at December 31, 2006.

A. Claims

(1) a. In December 1998 the Antitrust Commissioner published a notice concerning the investigation of *prima facie* suspicion of restrictive agreements in the field of public switching to which the Company was a party. The Antitrust Court recently approved an agreed order whereby the Company would pay NIS 2 million to the State Treasury without admitting violation of provisions of the Antitrust Law, and the Antitrust Authority would refrain from instituting proceedings in connection with the affair.

b. In September 2004, a claim and an application for certification as a class action were filed in the Jerusalem District Court against the Company and several other defendants (including Telrad and Tadiran) and against the State of Israel - Ministry of Communications as a formal defendant. The claim alleges that public switching cartels existed which gave rise to unnecessary expenditure for the Company, and an unjustified increase in its tariffs of an accumulated amount of NIS 1,750 million.

(2) A number of claims are pending against the Company concerning recognition of various salary components as pension components and recognition of various components in the determining salary for severance pay, as follows:

a. In September 2000, a claim was filed in the Jerusalem Regional Labour Court against the Company by 2,423 retired employees of the Company who were employees transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are seeking declaratory relief from the Labour Court, such that it will be determined that the payments they received for grossing up of tax, clothing allowance and incentive pay are considered part of the regular salary and therefore should be considered as part of their determining wage for the purpose of calculating their pension and the payments made to them upon retirement, and should be included in the calculation of hourly pay value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last, determining, salary for pension should be calculated according to the last salary which was paid to each of them for the last month of work, and not according to the average staff grade which each of them held. In 2004 the claim was dismissed *in limine*. An appeal filed against the decision was allowed, and the decision of the Regional Labour Court was set aside.

It is noted that in January 2007, another claim was filed by 85 retirees who transferred to the Company from the Ministry of Communications, seeking declaratory relief determining that payment of the grossing up of tax, clothing allowance and incentive pay should be included in the determining salary in the matter of rights by virtue of the Hours of Work and Rest Law and the Annual Vacation Law.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (Contd.)

(2) (Contd.)

b. In February 2002, a notice of a party to a collective dispute ("the Notice"), was filed in the Jerusalem Regional Labour Court by the New General Federation of Workers ("the Histadrut") in the name of all Company employees. The applicant alleges that payments for grossing up of tax, the component of administrative on-call duty benefits and clothing allowances which were and are paid to Company employees, are regular pay which form part of the determining salary of each employee, including with respect to the calculation of payments upon retirement, redemption of holiday pay, grants, acclimatisation payments, percentage increments and hourly pay value, and that various payments and provisions should be made in respect thereof, including for pension purposes. The Attorney General joined the claim. In April 2006, the Jerusalem Regional Labour Court issued its decision, dismissing all parts of the claim An appeal was filed against the decision, in which it was alleged that the decision is procedurally void, and the hearing was returned, with the consent of the parties and the Attorney General, to the Regional Labour Court.

c. In November 1995, a group of employees filed a claim against the Company in the Tel Aviv Regional Labour Court, concerning the inclusion of a number of components as part of the determining pay for pension. In August 2006, a decision was given in the case, dismissing the claim and all its component parts, and the Court ruled that the salary increments are not fictitious increments but true and conditional increments, and accordingly, are not part of the basic salary for the purpose of calculating the pension or severance pay, holiday pay and sick pay.

d. Some additional individual claims are pending against the Company, filed by employees and former employees, concerning recognition of various salary components as pension components, and recognition of various components in the determining salary for severance pay.

The maximum total exposure in respect of the above salary component claims is approximately NIS 3.2 billion.

(3) In September 2000, an action and an application for certification as a class action were filed against the Company in the Tel Aviv District Court. The amount of the claim is estimated at approximately NIS 110 million. According to the plaintiff, the Company unlawfully collected "collection fees" for Company bills which were not paid by their due date, since in fact the Company took no collection action until 14 days after the last date for payment as written in the telephone bill. The Court certified the claim as a class action suit. The Company filed an application for leave to appeal in the Supreme Court, which returned the case to the District Court for reconsideration of the application for certification in the accordance with the Class Action Law.

In October 2001, an additional class action was filed in the Tel Aviv District Court on exactly the same matter – unlawful charging of collection fees on Company bills not paid on time, before the Company had started any collection action. The amount of the class action was estimated by the plaintiff at approximately NIS 21 million. The Court approved suspension of the proceeding until after the decision on its certification as a class action or a ruling in the claim described above, due to the similarity in the cause of claim in the two cases.

(4) In September 2000, three plaintiffs filed a claim in the Tel Aviv District Court, together with an application for certification as a class action, against the Company, Bezeq International and the other international call operators, concerning the charge of VAT on international calls which originated from abroad. The plaintiffs estimated the total value of the claim in millions of shekels per year. The application for certification was dismissed, and the plaintiffs filed an appeal against the decision. Proceedings are in progress for filing an amended application in which the Company (a formal respondent) will be struck from the case.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(5) a. In March 2003, a claim was filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel, by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm allegedly caused by prohibited radiation from the Hillel broadcasting station. The amount of the claim stated by the plaintiffs is "more than NIS 15 million", and the same claim notes that the plaintiffs will also petition to split the reliefs so that they will reserve the right to sue later for other financial damages which are not bodily harm, such as damage to crops and loss of value of land.

It is noted that following an application for dismissal *in limine* filed by the Company, a partial decision was given in favour of the Company, dismissing the claim of five of the plaintiffs, who died before the Company started operating the station.

b. In June 2004, another claim was filed in the Tel Aviv District Court by 25 plaintiffs from Moshav Porath and Moshav Ein Vered, including 11 heirs to the estates of deceased persons, against the Company, the Broadcasting Authority and the State of Israel, for compensation in respect of bodily harm. The claim alleges violation of legislated duties, as well as and/or acts of omission by the defendants in connection with the operation of the Hillel station. The amount of the compensation demanded in the additional claim is not estimated (although the claim is in the jurisdiction of the District Court, i.e. more than NIS 2.5 million), and the compensation is based on financial and non-financial damages items which are listed in respect of each plaintiff, together with punitive compensation.

c. In May 2005, the Company received a claim for approximately NIS 46 million in damages, which was filed by 14 plaintiffs who were and/or are residents of the Moshavs Porath, Ein Vered, Ein Sarid and community of Kadima, against the Company, the Broadcasting Authority and the State of Israel. The claim alleges the violation of legislated duties in connection with the Hillel station, which resulted in bodily harm to he plaintiffs due to prohibited radiation.

The plaintiffs in these three claims have filed an application for consolidation of the hearings.

d. In May 2005, the Company received a claim for approximately NIS 141 million in damages, which was filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel. The claim alleges the violation of legislated duties in connection with the Hillel station, which resulted in property and financial damage. An application to split reliefs was also filed, which would enable future claims for damages. Twenty-three of the plaintiffs withdrew from the claim, and the amount of the claim of the remaining 30 plaintiffs was reduced to approximately NIS 35 million.

It is noted that on December 31, 2003, the Company ceased all services from the station, at the behest of the State and the Broadcasting Authority. Since that date, the Hillel station has not been a broadcasting site.

(6) In January 2002 a claim for payment of monetary compensation of approximately NIS 57 million and for writs of mandamus were filed in the Tel Aviv District Court by an international communications operator against the Company and Bezeq International. The claim is for damages allegedly sustained by that operator due to acts of commission and/or omission in connection with the customer allocation to the international call operators. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company. The file was transferred for mediation.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(7) In July 2002, the Company received a claim for monetary and declaratory relief, together with an application for certification as a class action. The claim alleges unlawful excess collection of interest in respect of arrears also in respect of payment which the Company collects for other communications providers. The total amount of the claim, if certified as a class action, is estimated by the plaintiffs in the tens of millions of shekels. The plaintiffs are petitioning for declaratory relief that the Company abused its monopolistic status and enriched itself unjustly. The request for certification of the claim was refused. The decision has been appealed in the Supreme Court.

(8) In May 2003, the Company received a claim and application for certification as a class action, which were filed against the Company in the Tel Aviv District Court. The amount of the claim is estimated at approximately NIS 2.5 billion (NIS 10,000 per consumer), which the plaintiff alleges is the loss suffered by the plaintiffs. The claim alleges that the Company refuses to install splitters for high speed internet lines, in order to increase its profits resulting in losses to private internet users. The court dismissed the claim, and the plaintiff appealed the decision.

(9) On December 25, 2005, a claim was filed against the Company in the Tel Aviv District Court, together with an application for certification as a class action, under the Consumer Protection Law, 5741-1981 alleging that the Company collects unlawfully, payments for surfing the internet with WOW's service, even though is technically unable to provide the service in certain areas at the promised speed. The plaintiffs estimate the amount of the class action at approximately NIS 100 million for all subscribers.

(10) In May 2006, a claim was filed in the Tel Aviv District Court together with an application for certification as a class action under the Consumer Protection Law and the Class Action Law, alleging deception in advertising in the matter of a charge for calls from a Bezeq line to a cellular line. According to the plaintiff, the Company deceived the public in its advertisements, which stated that the price of such a call would be "approximately 44 agorot per minute", whereas the exact price per call minute was 44.57 agorot, nor did it disclose that the charge for interconnect was made according to segments of 12 seconds, which means that the actual average charge was 49 agorot per minute. The plaintiff estimates the amount of the claim at approximately NIS 68.5 million (the amount of the individual's claim is NIS 11).

(11) Various municipalities and local councils submitted demands for retroactive payments of municipal property taxes for the increased area of buildings and a change of the classification for municipal tax purposes. The demands together total approximately NIS 80 million.

(12) In May 2006, a claim was filed in the Tel Aviv District Court together with an application for certification as a class action, against the cable companies and against the Company. According to the plaintiff, on May 17, 2006, a fault occurred in his telephone line in the HOT network and it is possible that Company employees played some part in the malfunction. The plaintiff alleges that as a result of the malfunction, he incurred financial damages, harm to his goodwill, and distress. The amount of the claim is estimated by the plaintiff at approximately NIS 100 million (the amount of the personal individual's claim is assessed at NIS 1,000).

(13) In November 2006, a claim and application for certification as a class action were filed in the Tel Aviv District Court, for the sum of approximately NIS 79 million. The claim alleges that the Company charged customers who connected to its ADSL service a monthly fee rather than a two-monthly fee, due to which they sustained losses and expenses.

(14) In November 2006, a claim and application for certification as a class action were filed against the Company in the Tel Aviv District Court, for the sum of approximately NIS 183 million, alleging unlawful collection of money in cases of disconnection due to non-payment.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(15) In November 2006, a claim and application for certification as a class action were filed by subscribers of the Company, Pelephone, Cellcom, Partner and HOT against the aforementioned companies, amounting to approximately NIS 158 million. The claim alleges that the plaintiffs were charged for a service they did not receive. The plaintiffs allege that upon termination of a call from a cellular to a fixed line, when the call is terminated by the fixed-line owner who received the call (and not by the cellular owner who initiated the call), the Company and HOT delay transmission of the disconnect signal for about 60 seconds. This results in damages suffered, reflected in airtime cost and interconnection fees.

(16) In November 2006, the claim and application for certification as a class action were filed in the Jerusalem District Court for the sum of approximately NIS 10.6 billion, against the Company, HOT, Pelephone, Cellcom and Partner, concerning the failure to implement number portability. See also section C(7) below.

(17) The Company has received a demand for the forfeiture of a guarantee in the amount of approximately $6.5 million related to a project (HBTL) in a basic telephony tender in 1995 in India, in which the Company participated, together with others. An appeal against an order given at the request of the project, preventing forfeiture of the guarantees, is being heard in the Appeals department of the High Court in Delhi. The Company has applied to the court in Delhi for release of the bank guarantees it provided.

(18) In November 1997 a claim was filed in the District Court, which together with an application for certification as a class action, against the Company, Bezeq International, the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner had determined that Bezeq International had abused its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs in that it refrained from clarifying to the public that only those who registered as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. In June 2001, the District Court decided to deny the application for certification. In September 2001, the decision of the District Court on this matter was appealed in the Supreme Court. The Supreme Court allowed the appeal in view of a procedural error of the District Court, and the case was returned to the District Court. In November 2005 the Court dismissed the application for certification as a class action and upheld the previous decision made by the court, adding that the application should also be dismissed since the applicant had no personal cause. In January 2006, the applicant filed notices of appeal in the Supreme Court.

(19) In September 2001, a revised statement of claim and an application for certification as a class action were filed against Bezeq International and the State of Israel. The plaintiff alleges that the tariffs for international telecommunication services during the period from May 10, 1996 through July 8, 1997, were exorbitant and unreasonable, and abused the status of Bezeq International as a monopoly, against a backdrop of falling prices as the international calls market was opening up to competition. In December 2003, the court allowed the application by virtue of the Antitrust Law and not on the basis of a cause arising from the Unjust Enrichment Law, and certified the claim as a class action. In February 2004, the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law. The Management of Bezeq International believes that if the claim is eventually certified as a class action by the Supreme Court and if it is allowed, the amount of the action could reach hundreds of millions of shekels.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(20) In December 2000, a claim was filed in the Tel Aviv District Court against Pelephone by the State of Israel, in respect of royalties allegedly payable for the period from January 1994 to February 1996. The amount of the claim is approximately NIS 260 million (including principal, linkage differentials and interest).

An examination conducted as part of a mediation proceeding found that the maximum amount of royalties on the revenues of Pelephone from January 1, 1994 to February 7, 1996 is only approximately NIS 118 million (before interest and linkage).

On February 16, 2004, the Company provided an undertaking to Pelephone, as approved by the Board of Directors on February 12, 2004, that if the mediation proceeding fails, the Company will pay Pelephone any sum it is ordered to pay to the State, if charged in a peremptory decision in respect of royalties for revenues from the provision of cellular services during the period from January 1, 1994 to October 10, 1994. According to the Company, it paid the State for that period under the settlement agreement between it and the State dated November 29, 1995. The undertaking to indemnify is subject to the presentation of the Company's arguments in the proceeding, and the consent of Pelephone for the Company to join the action as a third party should the Company request to do so.

(21) In September 2001, a claim was filed in the Ramallah District Court by the General Public Palestinian Communications Company ("Paltel"), against Pelephone and another company.

The plaintiff alleges that its license grants it, *inter alia*, the full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and cellular, for the supply of fixed and cellular communications services in the territory of the Palestinian Authority for an extended period, part of which being granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its requests to the defendants, they are continuing to provide cellular communications services to the inhabitants of the West Bank and the Gaza Strip, without restraint and without a license from the Palestinian Communications Authority, thereby violating various provisions of the law, prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority and a financial action for approximately NIS 676 million from Pelephone alone.

As at the date of signing these financial statements, the process of transferring the claim through the Attorney General has ceased and the alternative process of delivery effected by registered mail has been returned through the Ministry of Justice, and therefore this claim is not counted among the claims currently pending against Pelephone. It should also be noted that Pelephone does not recognize the jurisdiction of the court in Ramallah.

Pelephone learned that the Ramallah Court may have given a decision on the aforementioned claim. According to the Emergency Order (Judea, Samaria and the Gaza Strip – Jurisdiction in offences and legal aid) (Territories of the Palestinian Authority – Legal aid in civil matters), 5759-1999, enforcement of decisions given by a court of the Palestinian Authority may only be executed if approved by the Commissioner for Legal Aid at the Ministry of Justice. Pelephone considers that such a ruling – if made – was made without jurisdiction, contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations Law (Judea, Samaria and Gaza Strip – Jurisdiction in offences and legal aid), 5727-1967.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(21) (Contd.)
If an attempt is made to submit this decision for the approval of the Commissioner, or to enforce it in any way whatsoever, Pelephone will act to prevent such approval and/or enforcement and/or execution proceedings or the voidance of the reasons noted above which were behind the Commissioner's decision to prevent the service of the claim on Pelephone from the outset, as well as fact of the claim being heard in the Ramallah court without service of process in accordance with the order and the agreement constitutes a breach of the agreement and harms the autonomy of Israel, and that any decision given in such a claim is without validity.

(22) In November 2002, an application was filed for leave to appeal the decision of the Tel Aviv District Court from October 2002 to dismiss the application for certification of the applicant's claim against Pelephone as a class action. The claim was based on an allegation that throughout the years that Pelephone was a monopoly in the cellular market, it abused that status and collected inflated prices for its services. Therefore, the applicants requested that Pelephone be ordered to repay the surplus profits it collected to its customers, which they allege to be the amount of the claim (NIS 12.3 billion). On February 2, 2003, Pelephone filed its response to the application for leave to appeal.

(23) In December 2002, a claim, together with an application for certification as a class action, was filed in the Tel Aviv District Court against Pelephone and other cellular companies, for the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone.

The claim relates to amounts collected by Pelephone and another cellular company for incoming calls from May 10, 1996 to October 2, 2000. The applicants, through their lawyers, base their claim on the following allegations:

a. Every cellular operator is a monopoly in the incoming call service to its network. Pelephone and the other cellular operator abused their monopoly status in that they set high and unfair prices for the incoming call service to their networks. The correct and fair tariff for the incoming call service is 25 agorot per minute, and not as collected in the past by Pelephone and the other cellular company or as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.

b. Pelephone and the other cellular company violated obligations legislated under the authority of the Telecommunications Law, their licenses and the duty of good faith which require a reasonable price for a telecommunications service for which no price is set.

In July 2003 Pelephone filed its response to the application.

(24) In April 2003, an application was filed in the Tel Aviv District Court for certification of a class action in a total amount of approximately NIS 90 million, against all the cellular companies. The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming in to the network of each of them. The plaintiffs allege that this is a uniform, inflated, unreasonable and unfair tariff. The period to which the claim relates is from March-June 2002 through the date of filing the claim.

(25) In July 2006, a claim and an application for its certification as a class action were filed in the District Court against Pelephone, in the amount of approximately NIS 251 million. The claim relates to the interpretation of an agreement which the plaintiff signed with Pelephone for reimbursement of payments he was charged by Cellcom when he switched from Cellcom to Pelephone. According to the plaintiff, Pelephone should have paid NIS 3,000 in respect of those payments, even though he did not comply with the terms of the agreement. Pelephone is conducting procedural discussions with the plaintiff, in view of new applications he filed for amendment of the application for the class action. Pelephone will respond appropriately when these discussions are completed.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(26) In August 2006, a claim was filed in the District Court, together with an application for its certification as a class action, against Pelephone, Cellcom and Partner. The amount of the class action (consolidated against the three companies) is NIS 100 million. The claim relates to the time of disconnection of calls made from the cellular network to the Bezeq network, and alleges that in cases where the Bezeq customer initiated the call, a surplus charge is made until actual disconnection of the call.

(27) In February 2007, Pelephone received an application for certification of a class action filed against it in the Tel Aviv District Court. The claim concerns an allegation of misleading the defendant's subscribers who reside in Eilat, who were charged VAT for the cellular communication service. According to the claim, this charge contravenes the law in that Eilat is a free trade zone and therefore exempt from payment of VAT. The amount of the claim is approximately NIS 33 million. It is noted that other class actions have been filed against Partner and Cellcom for the same reason and in similar amounts.

Pelephone's Management, relying on its legal advisers, believe that a position cannot yet be formulated regarding this claim, especially since the entire question of VAT collection in Eilat will be referred to the State, the beneficiary of the collected VAT.
It is further noted that a similar class action was filed several years ago, which was eventually struck out by consent, in view of the position of the VAT Authority and the recommendation of the court.

(28) In June 2006, an application was filed in the Tel Aviv District Court for approval of a claim as a class action against DBS and against the cable companies, in connection with the broadcasting of commercials during the 2006 World Cup Games ("the Application for Approval"). According to the applicants, the broadcasting of commercials, which they allege were integrated into the first three days of broadcasts on the World Cup channel as part of the games and the World Cup studio, was against the law, contrary to the contract between DBS and its customers, and contrary to the terms laid down in the decision of the Council to approve the broadcasting of the 2006 World Cup Games. The applicants estimated the amount of the claim at NIS 106 million for all the members of the group (based on 200,000 World Cup subscribers of the cable companies and DBS together, calculated at NIS 530 per subscriber who purchased the World Cup package). On January 16, 2007, a hearing was held in the District Court, where it was decided that the Council for Cable and Satellite Broadcasts would file its position on the matters of the action within 45 days, after which the parties would be given time to respond to that position. In addition, it was decided that the applicants would furnish a copy of the statement of claim to the Attorney General within seven days.

(29) Miscellaneous claims – Various claims are pending against the Company and the Group Companies arising from the normal course of business. It is the opinion of the companies' managements that the latent risk in each of these claims will not cause material financial losses beyond the amounts included in the financial statements.

B. Claims in respect of which the exposure cannot yet be assessed or calculated

(1) In January 2004, a claim was filed in the Tel Aviv Regional Labour Court against the Company and against the Makefet Fund, by employees who retired under a retirement agreement signed in November 1997. The plaintiffs allege that they chose the Pension Track B after having been promised an increment pursuant to the "Yellow Note" agreement, and that this promise was not kept. The claim was originally filed by 66 retirees and today, the number of plaintiffs is approximately 300.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

B. Claims in respect of which the exposure cannot yet be assessed or calculated (contd.)

(2) In July 2004, an action for declaratory relief was filed in the Tel Aviv Regional Labour Court against the Makefet Fund, the State of Israel and the Company, by the Organization of Bezeq Retirees and six of its members, alleging that the defendants breached agreements for binding arrangements that were made upon the transfer of the employees from the civil service to the Company. According to the plaintiffs, their rights as retirees were acquired by the State and the Company in full actuarial balance and under binding agreements, and therefore, the pension reform that followed a change in legislation on June 1, 2003, does not apply to them.

(3) In February 2007, an action and application for its certification as a class action were filed in the Tel Aviv District Court against Pelephone, Cellcom and Partner, in a total amount of NIS 449 million. The amount attributed to Pelephone is NIS 167 million. The plaintiffs are suing for restitution of excess amounts which they allege were collected from the subscribers of the defendants, claiming that the defendants charged their subscribers for calls they made or received while they were abroad, according to a larger time segment than they were ostensibly permitted to charge, thereby seemingly violating the license. Pelephone is currently studying the claim.

(4) A number of proceedings have been served on Pelephone, in which local councils are seeking to join it as a party to appeals filed in appeals committees against the dismissal of claims for impairment under Section 197 of the Planning and Construction Law, in respect of the erection of communications installations. Pelephone studies each application on its merits, and decides on its course of action accordingly.

(5) In December 2005, an application was filed in the District Court which for approval of a claim against DBS as a class action. The reliefs applied for are as follows:

a. Monetary compensation for every customer who entered into an agreement with DBS by telephone and not in writing (leaving the amount to the discretion of the court. In the plaintiff's personal individual’s claim, NIS 20,000 is requested in compensation.).
b. Financial compensation in the amount which was overcharged, for whoever actually paid more than the amount agreed upon by telephone with representatives of DBS's service.
c. A declaratory order to DBS determining that from now on, whoever enters into an agreement with it by telephone will receive the arrangement in writing within 21 days.

On March 8, 2006, DBS filed an application for dismissal of the claim *in limine* before the decision was handed down.

C. Other contingencies

(1) On May 2006, investigators from the Antitrust Authority appeared in the Company's offices and presented an order of the Magistrate's Court permitting them to search the Company's offices and seize any document or object required for the investigation. According to the order, the cause of its grant was suspicion of abuse of status by a monopoly according to Section 29A of the Antitrust Law and Section 47(a)(4a) of the Antitrust Law and/or unreasonable refusal to provide an asset or service which is provided in monopoly as in Section 29 of the Antitrust Law. During the search, which has not yet been completed, the investigators collected various documents, including computerised material, and a number of employees were called for questioning at the Antitrust Authority offices. The Company cooperated fully with the Authority investigators. To the best of the Company's knowledge, the investigation has not yet ended, and accordingly, the Company believes, relying on its external legal advisor who is handling the case on its behalf, the results and implications of the investigation cannot be assessed at this stage, including the possibility that indictments will be filed ad/or civil proceedings will be instituted against the Company.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (Contd.)

(2) The Company received a letter on March 15, 2007, from a shareholder of the Company pursuant to Section 194 of the Companies Law, in which the Company is required to institute legal proceedings against the former CEO of the Company and the former VP Marketing of the Company, on the matter of the liability of a consolidated company, DBS, to the Company, and to take action for the collection of the debts of DBS to the Company. The Company intends to reject this demand, since, among other reasons, the debts were generated as a result of lawful activities of DBS as a marketer for the Company, and since the Company is acting to collect the debts, and has even reached a payment arrangement with DBS and DBS is repaying its debts regularly in accordance with the arrangement. The Company is unable to assess whether a claim will be filed on this matter by the shareholder, and at this stage is also unable to assess whether such a claim, if filed, is more likely than not to be successful.

(3) In August 2005 a claim was filed against the Government of Israel, the National Council, the Ministry of the Interior, the head of the Noise and Radiation Abatement Division (at the Ministry for Protection of the Environment), the cellular companies, including Pelephone, and a company named Elidav – Building & Investments Ltd. (the owner of a house in Ramat Hasharon on the roof of which cellular antennae were installed). The claim concerns the liability for claims under Section 197 of the Planning and Construction Law for the issuance of building permits for cellular antennae. The central allegation in the claim, as far as the cellular companies are concerned, is that in the proceedings for approval of National Outline Plan 36A, the cellular companies undertook to indemnify the local committees in respect of compensation those committees would be ordered to pay in claims under the aforementioned Section 197, and that the National Outline Plan was approved on the basis of that undertaking. According to the plaintiffs, the undertaking is tantamount to "a contract in favour of a third party" in their favour and in favour of the other local committees.

The plaintiffs also allege that the Government and the National Council were negligent in that they did not anchor that undertaking in the National Outline Plan, and once it transpired – after approval of the Plan – that the cellular companies were unwilling to indemnify the local committees, the Government and the National Council should have cancelled or suspended the Plan and should also have cancelled the franchises of the cellular companies.

The plaintiffs are petitioning for a large number of reliefs (about 20), all declaratory. The principal reliefs are to declare that the cellular companies and the other defendants must pay the compensation ruled against the local committees in claims under the aforementioned Section 197.

(4) In 2001, the Ministry of Communications issued administrative directives which regulate how a subscriber switches from the services of the cable companies to DBS and vice versa, and the use of infrastructures in the subscriber's home. The directives also prescribe a duty to pay monthly usage fees for infrastructure owned by the other multi-channel television service provider. Since the administrative directives were issued, DBS and the cable companies have submitted mutual complaints of violation of the directives by the other party, and voluminous correspondence has been exchanged between DBS and the Ministry of Communications on the matter. On August 15, 2005, the Ministry of Communications notified DBS and the cable companies that in view of their numerous violations of the administrative directives, it had re-examined the matter and was now considering their cancellation, *inter alia*, in view of the mechanism for purchasing the wiring prescribed in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (Contd.)

(4) (Contd.)

On November 2, 2005, DBS submitted its position to the Ministry of Communications, stating that the administrative directives should remain in place, while cancelling the early notice prescribed in them, which requires that notice be given to a party whose subscribers disconnect from its services. DBS also contended that the provisions of the law granting ownership of infrastructure to the multi-channel television provider that installs it in the homes of its subscribers, should be rescinded. At the very least, contended DBS, if the directive remains in place, its proper interpretation should not grant the cable companies ownership of the wiring it installed in private houses. DBS also stated that the amount prescribed in the law as the consideration to be paid for purchasing the wiring (NIS 120), is baseless and that if the directive is retained, the amount should be considerably reduced.

(5) On May 29, 2005, the media published a news item stating that Israel Police are conducting an investigation into "industrial espionage" by computerized means (a "Trojan horse" program), in which it was stated that the Company's subsidiaries Pelephone, Bezeq International and DBS, were involved

It is noted that a number of senior employees of the Company were called in by the Police immediately after the affair was publicised, to testify about confidential documents of the Company which were found on the premises of competing entities, and to assess the extent of the damage which the Company could expect as a result. The Company examined the matter and took immediate action to minimize, as far as possible, the risk of information being removed from the Company. It is further noted that some of the employees of these subsidiaries were called in for questioning.

In May 2005, the cable companies ("HOT") filed an *ex parte* application in the Tel Aviv District Court ("the First Application"), in which the court was requested to grant, among other things, an order for the appointment of a receiver, who would be authorised to search and seize, at all the sites held by DBS, commercial secrets of HOT as well as other information of HOT which is confidential or restricted by law, as well as other temporary reliefs, principally to prohibit DBS from using the commercial secrets of HOT.

The background to the filing of HOT's application was the publicity given in the press to the industrial espionage affair by means of Trojan horse software, where according to HOT, DBS ostensibly acted unlawfully, through the Modi'in Ezrachi investigation firm with which it had engaged, to enable it to obtain confidential information of HOT, thereby committing the tort of robbery of a commercial secret.

After dismissal of its application, HOT filed a claim against DBS, which does not include an application for any financial relief, in which the court is requested to grant a number of declaratory reliefs and *mandamuses* and injunctions concerned with prohibiting DBS from making use of commercial secrets of HOT.

In response to the application, DBS rejected HOT's allegations and gave notice that without waiving any of its allegations, it was willing to undertake to refrain from making any use of documents related to HOT's business which had come into its possession from Modi'in Ezrachi, and that should any such document or information be found, that document would be sealed in an envelope and placed in a safe. On July 7, 2005, the court, with the consent of the parties, issued a decision, which validated as a court judgement, DBS's notice not to make any use of documents and information transferred to DBS by Modi'in Ezrachi. In practical terms, this means that the court dismissed HOT's applications for appointment of a receiver and for grant of a temporary injunction of broader scope than DBS's commitment.

On June 30, 2005, DBS filed a defence in court, in which it denied the allegations in the claim made by HOT. A hearing has not yet been scheduled.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (Contd.)

(5) (Contd.)

On July 12, 2005, HOT field an application to split reliefs so as to enable it to file a financial claim against DBS in a separate claim. On September 18, 2005, DBS filed a response, requesting dismissal of HOT's application.

On September 5, 2006, the court issued a decision directing HOT to give notice of whether it intends to continue with its application to split reliefs. On September 26, 2006, HOT filed notice in court that it intends to continue with the application and that it requests that the court allow the application as is until the pre-trial date of the claim. On the same date, the court gave its decision allowing HOT's request to leave the application as is until the pre-trial date.
The first pre-trial hearing is scheduled for May 21, 2007.

DBS, noting the fact that no financial claim has yet been filed, the fact that no decision has yet been given on the application to split reliefs, as well as the innovation and complexity of the legal questions arising in the claim, and relying on its legal advisers, cannot assess, at this stage, whether the claim is more likely than not to succeed.

In addition, in November 2005, a claim was filed in the Tel Aviv District Court against Pelephone, for an order to provide a financial report, together with an application to split reliefs. The cause of claim revolved around allegations whereby, as it were, Pelephone had "ordered" business information about the Plaintiff's business and this was supplied by defendant no. 2 (Modi'in Ezrachi) by way of violating a number of provisions of law and as part of the Trojan horse affair. The defence has not yet been filed.

(6) For the provision of their services, the Company and the subsidiary Pelephone operate installations which emit electromagnetic radiation. The operation of such installations is subject to the Non-ionizing Radiation Law, 5766-2006, ("the Radiation Law") the majority of whose instructions are valid from January 1, 2007, and the Pharmacists Regulations (Radioactive elements and their products), 5740-1980, which regulate the erection, operation and supervision of these installations, including a requirement for permits for that purpose. Erection and operation permits are granted by the Supervisor of Radiation at the Ministry for Protection of the Environment, and grant of an operator's license necessitates presentation of a permit under the Planning and Construction Law. The Company and Pelephone are at an advanced stage of preparation and adaptation of their installations for operation in accordance with the provisions. The Company is acting to obtain building permits, to the extent required, for its broadcasting installations, as well as working with the Ministry of the Interior and the Ministry for Protection of the Environment on the implementation of National Outline Plan 36B, which deals with building permits for large broadcasting installations. The subject of electromagnetic radiation and its effects has not yet been thoroughly investigated in Israel or elsewhere. The Company and Pelephone are using their best efforts to meet the requirements of the Radiation Law, including concerning the permits required. Nevertheless, the managements of the Company and Pelephone are unable to assess whether all the approvals will be received within the time prescribed in the Radiation Law, and what the implications of the above might be.

(7) On March 29, 2005, the Knesset enacted the Economic Policy Law for the 2005 Financial Year (Legislative amendments), 5764-2004 which includes, *inter alia*, amendment of the Communications Law (Telecommunications and broadcasts), 5742-1982 whereby the Minister of Communications will prepare a plan for number portability for general license-holders (including holders of special general licenses) for fixed-line domestic communication services, and a general license-holder for the provision of cellular services, and will instruct them concerning its application and operation by September 1, 2006 (if the Ministers of Communications and Finance see a genuine need and special reasons, they may postpone, in an order approved by the Knesset Economics Committee, postponement of the application and operation of the plan for not more than three months).

On August 22, 2005, the Ministry of Communications signed a numbering portability plan.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (Contd.)

(6) (Contd.)

As the Company noted in the position paper it submitted to the Ministry of Communications, the timetables set in the law for application of the plan cannot be met. Furthermore, the Company believes that the implementation of number portability could require it to make considerable financial investments in replacing software and hardware versions in its switching network, and that large investments will be required in its information systems, which could also lead to postponement of the Company's development plans in this area. In addition, the operation of number portability involves costs in respect of shared records and management with the relevant operators – costs which cannot be assessed at this stage. As well as these costs, the implementation of number portability, which is expected to ease the transition of customers from the Company's networks to competing networks, could have an adverse effect on the ability to of the Company and the other companies in the Group, to compete.

On August 23, 2006, the Ministers of Communications and Finance announced that implementation of the plan would not be postponed beyond September 1, 2006,. Their notice also stated that the Director General of the Ministry of Communications recommended that if the plan is not implemented and operated by September 1, 2006, "… the relevant communications companies would be declared in violation of the law, together with all relevant implications thereof." Following that decision, on August 24, 2006, both the Company and Pelephone (together with other cellular companies), filed petitions in the High Court of Justice, for an order *nisi* against the Government of Israel and the Minister of Communications. The petitioners contend, *inter alia*, that even though they had worked assiduously to apply the plan, investing considerable resources for that purpose, they are unable to comply with the unrealistic timetables laid down in the law. In the background – the Ministry of Communications, according to the petitioners, has not prepared a numbering plan for number portability and had not determined the payment structure which would apply between the entities involved, as it was required to do according to the provisions of the law. The State filed its initial response to the High Court of Justice, in which it sought dismissal of the petition *in limine*. The hearing of the petition was postponed to July 30, 2007.

(8) For possible demand for early repayment of bank loans, see Note 13.

NOTE 18 - COMMITMENTS

(1) Commitments for lease agreements and rentals

Contractual rental payments in the next 5 years, calculated according to the rent in effect at December 31, are as follows:

For the year ended December 31,	**NIS thousands**
2007	**214,927**
2008	**175,708**
2009	**136,312**
2010	**109,508**
2011 and onwards	**160,371**
	796,826

(2) At December 31, 2006, DBS has agreements for the purchase of broadcasting rights amounting to approximately NIS 137 million.

NOTE 18 - COMMITMENTS (CONTD.)

(3) DBS entered into an agreement for leasing space segments of the Amos 1 and 2 satellites with Israel Aircraft Industries ("IAI") and with the satellite communications company Spacecom Limited ("Space"). The contractual annual lease fees in the coming years under those agreements are as follows:

	NIS thousands
2007	**109,005**
2008	**112,554**
2009	**98,918**
2010	**101,611**
2011	**101,611**
From 2012 until the termination of the contract	**474,199**
	997,898

In May 2003, an agreement was signed with IAI, regulating the debts of DBS in respect of leasing the space segments for the period up to May 2002. At the date of approval of the financial statements, only partial payment has been made on account of the lease fee debt for the prior periods which are overdue. In view of DBS's arrears in the payments prescribed in the above agreement, in March 2006 IAI demanded settlement of the entire debt and the interest on it. Since IAI's demand, DBS and IAI have been negotiating settlement of the debt. Based on this situation, the balance of the liabilities is shown under short-term borrowing, including a provision for arrearage interest in accordance with an assessment made by DBS's Management.

In addition, DBS and Space are in dispute in respect of the amount of the annual payments, concerning DBS's entitlement to a certain discount on the lease fees. DBS pays Space the amounts not in dispute, and also paid an additional one-off amount. On February 12, 2007, Space notified DBS that it was still insisting that the amount in dispute be deposited with a trustee until settlement of the dispute, a position which DBS rejects. Up to the date of approval of the financial statements, Space has taken no action to enforce its rights.

(4) The Group has a number of operation lease agreements for periods of 3 to 4 years in respect of vehicles it uses. The contractual annual lease fees, calculated according to the fees in effect at December 31, 2006, are approximately NIS 233 million.

(5) In accordance with the requirements of the license and the principles laid down by the Council for Cable and Satellite Broadcasts, in 2006 and 2007 DBS must invest in content broadcasts not less than 8% of its revenues from subscriber fees in local productions.

(6) At December 31, 2006, DBS has agreements to buy purchased channels. In the year ended December 31, 2006, the expenses for consumption of purchased channels amounted to approximately NIS 251 million.

(7) Right to purchase a usage right in frequencies

The grant of frequencies which Pelephone won in a tender published by the Ministry of Communications (see Note 32(1)), was made subject to terms which include, among others, payment of NIS 225 million (plus Accountant General's interest, except on the first, Index-linked payment) for the new frequency ranges, and provision of a guarantee in the amount of $20 million to secure the terms of the license, which was amended in 2004 to $10 million. The payment due upon winning the tender was supposed to have been made in six different instalments, spread over the period to 2006.

On March 16, 2004, Pelephone agreed to a proposal of the Ministries of Communications and Finance concerning a reduction of NIS 33 million from the original payment set in the tender, against (1) payment of the balance of the license fee of approximately NIS 99 million during 2004; (2) return of the frequencies to the State, so that Pelephone would not owe payment of frequency fees for them from 2003 onwards.

NOTE 18 - COMMITMENTS (CONTD.)

(7) (Contd.)

In addition and concurrently, Pelephone was granted a right to a future allocation of these frequencies, for the exercise of which, Pelephone would pay the amount deducted, plus the frequency fees in respect of the relevant period, plus customary linkage differentials and interest. Between March and August 2004, Pelephone paid the aforementioned balance of the license fee – NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Ministry of Communications, informing it that in an amended calculation made by the Ministries of Communications and Finance, the amount Pelephone would be required to pay upon future allocation of the frequencies, is NIS 51 million, and not the NIS 33 million agreed in March 2004. Pelephone has not presented its position on this to the Ministries.

(8) On December 13, 2006, Bezeq International signed a transaction for the purchase of 100% of the shares of Actcom – Active Communications Ltd. ("Actcom"), the oldest-established provider of internet access services in Israel, from its two founders, in consideration of US $3 million (10% of the amount of the consideration was contingent upon the transfer of at least 90% of Actcom's existing customers on the date of signing the agreement). The purchase transaction was closed on January 3, 2007. As a result of the acquisition, Bezeq International generated a surplus cost of approximately NIS 16 million, which will be attributed, in accordance with IFRS 3 provisions, to the fair value of tangible assets, intangible assets and liabilities acquired at the date of closing the purchase transaction, based on a PPA (Purchase Price Allocation) paper.

(9) In February 2004, Bezeq International entered into an agreement with Mediterranean Nautilus Ltd. ("Med Nautilus"), for the purchase of an indefeasible right to use sea-bed cable capacity. In addition, the agreement grants Bezeq International options for an additional purchase from Med Nautilus of an indefeasible right to use sea-bed cable capacity. Some of the options were exercised in 2004, and the remainder were exercised in June 2006. In October 2006 another agreement was signed with Med Nautilus, for an additional purchase of an indefeasible right to use sea-bed cable capacity in 2007, in a total amount of approximately NIS 74 million. This agreement also grants an option for an additional purchase of capacity from Med Nautilus in the future.

(10) For engagements for the purchase of property, plant and equipment, see Note 9G.

NOTE 19 – SECURITIES, CHARGES AND GUARANTEES

(1) In May 2003, the Company provided, at the behest of the Ministry of Communications, a bank guarantee of $10 million in connection with its general license for implementing telecommunications operations and for providing telecommunication services. On June 22, 2005, the Company received a letter from the Director General of the Ministry of Communications, giving notice of the decision of the Ministry to call in NIS 10 million of the $10 million bank guarantee provided by the Company in connection with its general license. The Director General's letter stated that the decision to foreclose was made in light of the fact that the Company had made commitments to the institutional investors who provided loans to DBS, in which the Company holds 49.8% of the share capital, in a way which contravenes the directives of the Minister of Communications.

It is noted that since the Minister of Communications made her decision to impose restrictions and conditions on the Company's injections to DBS, both DBS and the Company acted without regard for their legal position on the absence of authority of the Minister of Communications to intervene in the matter of injections made by shareholders and other financing entities to DBS, with the purpose of complying with the conditions and restrictions imposed by the Minister of Communications and at the time also by the Antitrust Commissioner, as well as the legal action they had instituted both in the High Court of Justice and in the Antitrust Court (in a proceeding which has already been terminated, since the term of the restriction imposed by it had elapsed). The position of the Company is that there is no legal or other basis for calling in part of the guarantee of which the Director General notified the Company, and therefore no provision was made in the financial statements. An appeal against the decision was submitted to the Minister of Communications, due to which, for the time being, implementation of the foreclosure is frozen. As noted in Note 32(3) below, the hearing of the appeal of

NOTE 19 – SECURITIES, CHARGES AND GUARANTEES (CONTD.)

(1) (Contd.)

the Company and DBS in the High Court of Justice against the Minister of Communications, was held on October 11, 2005, but no ruling has yet been given in the proceeding.

(2) The Company provided a guarantee in favour of banks in connection with credit of up to NIS 70 million granted to a subsidiary.

(3) For guarantees provided by the Company for its past investments in India, see Note 17A(17).

(4) The Company provided a guarantee of approximately NIS 10 million for DBS in respect of a bank guarantee of approximately NIS 33 million which DBS had provided in favour of the State of Israel. The guarantee is valid until December 31, 2010.

(5) In February 2002 and May 2005, at the demand of the Ministry of Communications, Bezeq International provided bank guarantees of approximately NIS 9.4 million and NIS 1.4 million respectively, for fulfilment of all the terms of the license to provide international telecommunication services. In December 2004, at the behest of the Ministry of Communications, Bezeq International provided a bank guarantee of approximately NIS 340,000 for fulfilment of the terms of a special license granted it for a marketing trial for the provisions of VOB services. At the balance sheet date, Bezeq International had provided additional bank guarantees in a total amount of approximately NIS 3.2 million.

(6) Pelephone provided guarantees of approximately NIS 72 million in favour of third parties, of which approximately NIS 42 million in favour of the Ministry of Communications, in connection with a guarantee for fulfilment of the terms of its license.

(7) To secure its liabilities, DBS provided documentary credit and guarantees amounting to approximately NIS 39 million (including a bank guarantee of NIS 33 million in favour of the State of Israel).

(8) The shareholders in DBS (except for one of them) have encumbered their shares in favour of the banks. In view of a negative pledge of the Company (see Note 13), the Company provided the banks with a perpetual guarantee for payment of the debts of DBS. The guarantee is up to a maximum amount equal to the percentage of the Company's holding in DBS, multiplied by the value of DBS as derives from realisation of the pledged shares of the other shareholders. If the Company joins the sale in the framework of realisation of the pledged shares of the other shareholders, the amount of the guarantee will not exceed the amount of the proceeds the Company will receive from realisation of its shares in DBS. The guarantee note includes numerous restrictions on the Company in realising the shares it holds, and lists violation events which, if committed, will enable the banks to call in the guarantee. Furthermore, the Company also undertook to put its shares up for sale if the shares pledged by the bank are sold, and agreed that in case of realisation of collateral provided by the other shareholders, the Company would forgo repayment of shareholder loans provided for DBS and that the guarantee would apply, *mutatis mutandis*, also to stock options which the Company receives from DBS and to the right to receive them.

The shareholders in DBS, except for one of them, undertook towards the banks not to oppose the sale or other realisation of their shares in DBS, which were encumbered or for which a guarantee was provided (by the Company), in a way that will enable the banks to accomplish a friendly liquidation.

(9) For securities, charges and stipulations given by the Company and associates in connection with loan covenants, see Note 13.

NOTE 20 – SHAREHOLDERS' EQUITY

A. Share capital

	Registered		Issued and paid in	
	December 31, 2006	December 31, 2005	December 31, 2006	December 31, 2005
	No. of shares	No. of shares	No. of shares	No. of shares
Ordinary shares of NIS 1 par value	**2,625,000,000**	2,625,000,000	**2,605,045,611**	2,605,045,611

B. Following completion of the sale of 30% of the State's shares in the Company to Ap.Sb.Ar. (see also Note 1) on October 11, 2005, the State's holdings in the Company decreased to 16.38%.

C. The Board of Directors of the Company, at its meeting on March 1, 2006, decided that resolutions concerning distribution of a dividend would be passed specifically, in accordance with the financial results of the Company, its financial situation and other relevant circumstances and data. This resolution superseded earlier resolutions in the matter of dividend policy.

D. The Company also issued options for shares to employees (see Note 26).

Capital reserve for assets available for sale
A fair value reserve includes the net cumulative change in the fair value of financial assets available for sale, until the assets are disposed of.

Capital reserve for activities between the Company and a controlling shareholder
This reserve relates to benefits granted by the State as controlling shareholder in the Company, to employees, in cash and in equity instruments of the Company.

Capital reserve for employee stock options
This reserve relates to a benefit granted to employees by means of share-based payments.

Dividends
The following dividends were announced and paid by the Group:

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
In April 2006 a cash dividend was distributed (NIS 0.46 per share)	1,200,000	–
In October 2006 a cash dividend was distributed (NIS 0.15 per share)	400,000	–
In November 2006 a cash dividend was distributed (NIS 0.12 per share) (1)	300,000	–
	1,900,000	–

(1) The dividend was paid in January 2007.

E. On December 28, 2006, the general meeting of the shareholders of the Company approved the recommendation of the Board of Directors of the Company concerning distribution of a cash dividend of NIS 1,800,000,030 (comprising NIS 0.69 per share), as a distribution not in compliance with the earnings test. The distribution was subject to the approval of the court, and on December 31, 2006 the Company filed an application in the court for approval of the distribution. On February 4, 2007, the court approved the distribution, and the distribution was made on February 26, 2007. No liability in respect of this distribution was recorded in the financial statements.

F. After the balance sheet date, the general meeting of the Company approved an increase in the registered capital of the Company by 124,000,000 ordinary shares of NIS 1 par value each, which will be equal in all their rights to the ordinary shares of NIS 1 par value of the Company, so that together with the balance of the existing registered capital, the registered capital of the Company will be 2,749,000,000 ordinary shares of NIS par value each.

NOTE 21 – REVENUE

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Fixed-line domestic communications	**5,086,022**	5,165,393
Cellular telephone	**3,493,541**	3,302,393
Multi-channel television	**1,284,337**	1,171,318
Sale of equipment to subscribers, installations and miscellaneous	**1,170,771**	1,246,897
International communications and internet services	**963,942**	773,794
	11,998,613	11,659,795
Other revenues	**233,217**	264,923
	12,231,830	11,924,718

NOTE 22 – SALARIES

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Salaries and related expenses –		
Operating	**1,784,674**	1,809,396
General and administrative	**727,142**	649,106
Share-based payments	**286,506**	345,674
Total salaries and incidentals	**2,798,322**	2,804,176
Less – Salaries attributable to investments in property, plant and equipment	**211,885**	218,396
	2,586,437	2,585,780

NOTE 23 – OPERATING AND GENERAL EXPENSES

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
General expenses	**1,169,107**	1,257,809
Materials and spare parts	**922,449**	930,666
Consumption satellite services content	**441,268**	419,309
Cellular telephone expenses	**1,854,347**	1,816,301
Building maintenance	**347,849**	366,736
Services and maintenance by sub-contractors	**428,424**	422,416
International communication expenses	**383,496**	276,819
Motor vehicle maintenance expenses	**190,079**	181,385
Royalties to the Government of Israel	**179,589**	257,429
Collection fees	**50,008**	49,196
	5,966,616	5,978,066

NOTE 24 – OTHER EXPENSES (INCOME), NET

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Provision (cancellation of provision) in respect of severance pay in early retirement	**309,108**	(83,000)
Net capital gains mostly from realisation of real estate	**(159,017)**	(8,646)
Provision in respect of contingent liabilities	**96,322**	-
Others	**3,127**	(8,195)
	249,540	(99,841)

NOTE 25 – FINANCING EXPENSES, NET[1]

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Interest income from bank deposits, investments and others	**194,651**	158,279
Income in respect of borrowing grossed up in sales net of discounted fee	**49,405**	44,482
Interest income from financial assets available for sale and from embedded derivatives	**30,233**	8,790
Net earnings from financial assets available for sale transferred from the equity	**5,218**	104,582[2]
Net gain in respect of rate of exchange differences	**-**	81,600
Other financing income	**76,918**	35,561
	356,425	433,294
Interest expenses in respect of financial liabilities	**477,171**	494,418
Net loss in respect of linkage differentials	**5,775**	126,529
Net loss in respect of exchange rate differences	**11,760**	-
Net movement in the fair value of financial assets measured at fair value through profit and loss	**153,221**	127,887
Other financing expenses	**46,466**	55,758
	694,393	804,592
Financing expenses, net	**337,968**	371,298
(1) Net of amounts capitalised in the amount of	**1,207**	7,797

(2) The Company held 0.7405% in the satellite corporation Intelsat. On November 17, 2004, Intelsat gave notice confirming the intention to sell the corporation. The Company's share in the consideration was approximately NIS 104 million. A capital gain in the full amount was recorded in 2005.

NOTE 26 – SHARE-BASED PAYMENTS

a. Following the offer for sale to the public in a prospectus of the Company and the State dated May 24, 2004, and completion of the sale of the controlling interest in the Company from the State to Ap.Sb.Ar on October 11, 2005, the Company's employees are entitled to compensation for these sales by means of an allocation of 4.71% of the shares of the Company which are held by the State. Allocation of the shares will be by means of a stock options plan in accordance with an outline published by the Company on November 15, 2005.

b. Following the agreement signed with the employees (see Note 16E) in the matter of an employee stock options plan comprising 3% of the issued and paid up share capital of the Company, the Board of Directors of the Company gave its final approval for the employee stock options plan on February 22, 2007. The options were allocated on March 25, 2007 (except for options to two employee-directors, the allocation of which will be subject to and after approval of the general meeting, which is scheduled for April 15, 2007). The expenses for this grant were recorded in 2006, since the promise was made to the employees that year, with the terms of the grant, and the value of its grant was determined at February 22, 2007, which was the date of the grant.

The terms of the grants are as shown below (all the options are settled by way of physically handing over the shares):

Date of grant / eligible employees	No. of instruments in thousands	Vesting	Contractual duration of the options
Grant of options from the State to employees on October 11, 2005	122,698	Immediate (subject to lock-up – commencing at the end of two to three years – one third each year)	4 years
Grant of options to employees on February 22, 2007[(1)]	78,151	Immediate (subject to lock-up for two years)	5 years
Total options for shares	200,849		

(1) Including 59,000 options to two employee-directors, as noted in sub-section b. above.

The number and the weighted average of the exercise price of the options stock options are as follows:

	No. of options 2006	No. of options 2005
Balance at January 1	**122,698**	122,698
Options granted during the period	**78,151**	-
Options for exercise as at December 31	**200,849**	122,698

The weighted average of the exercise price on 2006 and 2005 is NIS 3.494 per share and NIS 4.057 per share, respectively.

For the balance of the options issued at December 31, 2006, the exercise price is in the range of NIS 3.327 to NIS 3.339, and the weighted average contractual life is 4.4 years.

The fair value of the services received in consideration of the stock options granted, is based on the fair value of the granted options measured on the Black and Scholes model, based on the following parameters:

NOTE 26 – SHARE-BASED PAYMENTS (CONTD.)

The fair value of the options and the assumptions

	2006	2005
Fair value at the time of grant	**3.653**	2.817
Share price	**6.678**	6.400
Exercise price	**3.339**	4.037
Anticipated volatility (weighted average)	**21.00%**	25.25%
Useful life of the option (anticipated weighted average)	**3.00**	3.39
Risk free interest rate (based on government debentures)	**3.20%**	2.45%

Salary expense

	2006	2005
	NIS thousands	NIS thousands
Share options granted in 2005	**-**	345,674
Share options granted in 2006	**286,506**	-
Total expenses charged to salary expenses	**286,506**	345,674

c. After the balance sheet date, on February 27, 2007, the Board of Directors of the Company approved an allocation of 56,836,888 options to the senior management of the Group, exercisable for up to 56,836,888 ordinary shares of NIS 1 par value each of the Company, which are approximately 2.1818% of the issued capital of the Company before allocation of the options.

In view of the enquiry of the Securities Authority into the matter, and as a result of an investigation carried out by the Company into the process of approval of the plan, the Board of Directors of the Company resolved, on March 15, 2007, to cancel this stock options plan and the outline published for it. The Board of Directors intends to act for the formulation of a compensation plan for the senior managers instead of the one cancelled.

d. (1) The employment agreement of DBS with a number of senior employees provides that if DBS adopts an employee stock options plan in which employees will be granted a right to purchase shares of DBS, the plan will include those employees. The exact number of options each employee will receive in the plan will be determined at the exclusive discretion of the Management of DBS. At the date of signing the financial statements, DBS has not adopted an employee stock options plan, and therefore, no options have been allocated.

(2) Under the employment agreements of DBS with a number of senior employees, DBS undertook to grant each such employee options warrants whereby each of them will be entitled to purchase from DBS, by way of an allocation of ordinary shares of NIS 1 par value each, in consideration of their par value, so that after exercise of the option warrants, the number of shares that will be held by any one employee will be approximately 0.2% of the issued share capital of DBS, based on the issued share capital on the date of signing the employment agreement with that employee, and noting certain protections against dilution which are included in some of those agreements. Each employee may exercise the option warrants for shares in accordance with the terms provided in the agreement with him. These options have not yet been granted. The allocation requires the approval of the board of directors of DBS and of the banks. In view of the aforesaid, the provisions of IFRS 2 were not applied on the matter of equity grants to employees.

NOTE 26 – SHARE-BASED PAYMENTS (CONTD.)

(d) (Contd.)

(3) Under the employment agreement of the CEO of DBS, DBS undertook to allocate to him options exercisable for ordinary shares of NIS 1. The options will be allocated free of charge, and will be exercisable free of charge, for shares comprising, on the date of the agreement, 0.5% of the issued share capital of DBS.

The entitlement of the CEO of DBS to shares will be established gradually, along the period of his employment at DBS. At the date of approval of these financial statements, these options have not been allocated. The allocation requires the approval of the board of directors of DBS and of the banks. In view of the aforesaid, the provisions of IFRS 2 were not applied on the matter of equity grants to employees.

NOTE 27 – EARNINGS PER SHARE

Basic and diluted earnings per share

Calculation of the basic and diluted earnings per share at December 31, 2006 was based on the earnings attributable to the ordinary shareholders, of NIS 808,995 thousand (2005 – NIS 666,411 thousand), and on a weighted average number of ordinary shares in circulation of 2,605,046,000 shares, as follows:

	2006	2005
	NIS thousands	NIS thousands
Profit (loss) attributable to the ordinary shareholders		
Profit (loss) attributable to the ordinary shares	**808,995**	666,411
Weighted average of the number of ordinary shares		
Weighted average of the number of ordinary shares	**2,605,046**	2,605,046

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NOTE 28 – SEGMENT REPORTING

The Group operates in various segments in the communications sector, so that every company in the Group operates in a separate business segment. The primary reporting format, by business segments, is based on the Group's management and internal reporting structure.

Each company provides services in the segment in which it operates, using the property, plant and equipment and the infrastructure it owns. The infrastructure of each company is used only for providing its services. Each of the companies in the Group is exposed to different risks and yield expectations, mainly in the matter of the technology and the competition in the segment in which it operates,

Accordingly, the separating component in the Bezeq Group which provides a service or a group of related services, and which is exposed to different risks and yield expectations than those of other segments, is every company in the Group.

Based on the above, the business segments of the Group are as follows:

- Bezeq, The Israel Telecommunication Corp. Ltd. – fixed line domestic communications.
- Pelephone Communications Ltd. – cellular communications.
- Bezeq International Ltd. – international communications and internet services.
- D.B.S. Satellite Services (1998) Ltd. – multi-channel television.

The other companies in the Group are presented in other sections.

Inter-segment pricing is set at the price determined in a transaction between unrelated parties.

NOTE 28 – SEGMENT REPORTING (CONTD.)

The results, assets and liabilities of a segment include items directly attributable to a segment, as well as those that can be allocated on a reasonable basis. Unallocated items comprise mainly investments (excluding real estate for investment) and the income from them, loans and borrowings and their related expenses, corporate assets and expenses of the Group, and assets and liabilities for taxes.

Segment capital expenditure is the total cost incurred during the period to acquire property, plant and equipment and intangible assets which are not goodwill.

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation

	Year ended December 31, 2006						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	5,193,493	4,462,077	1,016,300	1,338,826	221,134	-	12,231,830
Inter-segment revenues	605,503	15,910	21,519	23,563	97,545	(764,040)	-
Total revenues	5,798,996	4,477,987	1,037,819	1,362,389	318,679	(764,040)	12,231,830
Segment results	746,320	691,682	131,416	7,707	(11,923)	-	1,565,202
Financing costs, net							(337,968)
Net earnings							1,227,234
Equity in profits of investees accounted by the equity method							11,184
Earnings before income tax							1,238,418
Income tax							488,393
Net profit							750,025
Attributed to:							
Shareholders of the Company							808,995
Minority interest in a consolidated company							(58,970)
Earnings for the year							750,025

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2006						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Segment assets	9,756,868	3,375,001	454,918	838,793	186,391	172,230	14,784,201
Investment in investees accounted by the equity method							32,122
Unallocated assets							2,728,337
Total assets							17,544,660
Segment liabilities	2,319,960	756,043	272,219	583,524	107,151	208,823	4,247,720
Unallocated liabilities							8,106,195
Total liabilities							12,353,915
Capital expenses	511,488	337,424	39,713	208,032	9,013		
Depreciation	874,759	407,289	35,047	268,411	5,548		
Amortisation of intangible assets	128,216	63,301	20,205	24,561	11,274		
Losses from impairment of intangible assets and property, plant and equipment	5,314	-	-	-	551		
Share-based payments	286,506	-	-	-	-		

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenue							
Revenues from external sources	5,285,006	4,413,423	825,801	1,200,866	199,622	-	11,924,718
Inter-segment revenues	60 7,947	14,854	21,488	20,997	104,511	(769,797)	-
Total revenue	5, 892,953	4,428,277	847,289	1,221,863	304,133	(769,797)	11,924,718
Segment results	919,138	585,183	99,644	(78,440)	1,411	-	1,526,936
Financing costs, net							(371,298)
Net earnings							1,155,638
Equity in losses of investees accounted by the equity method							(3,320)
Revenue before income tax							1,152,318
Income tax							532,015
Net profit							620,303
Attributed to:							
Shareholders of the Company							666,411
Minority interest in a consolidated company							(46,108)
Earnings for the year							620,303

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Segment assets	9,638,637	3,591,679	525,114	941,693	218,100	198,372	15,113,595
Investment in investees accounted by the equity method							20,368
Unallocated assets							4,253,875
Total assets							19,387,838
Segment liabilities	2,325,410	740,838	238,555	592,299	118,752	186,616	4,202,470
Unallocated liabilities							9,130,126
Total liabilities							13,332,596
Capital expenses	763,649	503,885	36,095	266,034	15,824		
Depreciation	970,853	380,294	46,499	257,959	10,254		
Amortisation of intangible assets	130,738	58,265	18,118	26,078	7,911		
Share-based payments	345,674	-	-	-	-		

NOTE 28 – SEGMENT REPORTING (CONTD.)

B. Segmentation of the Group's income

Below is further information of the segmentation of the Group's income by customer use. The attribution of the costs relating to this income is not possible, since the Group's expenses relating directly to them cannot be identified, nor can they be reasonably allocated.

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Telephony – domestic calls, fixed fees and installations	**4,139**	4,274
Cellular telephone	**4,262**	4,191
Multi-channel television services to subscribers	**1,284**	1,171
Internet	**982**	867
International communications	**722**	562
Transmission services and data communication	**590**	584
Fixed line infrastructure and maintenance works	**200**	221
Others	**53**	55
Total	**12,232**	11,925

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. The Company and its consolidated companies provide a range of communication services, such as telephony, access, information and data communication, transmission, satellite and video, infrastructure, international communications and internet, multi-channel television, cellular, network end point, and others ("the Services").

Among the entities for which the Company and its consolidated companies provide the Services, there are also parties with an interest in the Company, including Ap.Sb.Ar, which holds 30% of the Company's shares, the State of Israel, which holds 16.38% of the Company's shares, and the Zeevi group, which holds 17.75% of the Company's shares through a receiver appointed for those shares on behalf of certain banks.

In view of the above, as far as parties with an interest in the Company are concerned, which are not the State of Israel, the Services provided for them by the Company and its subsidiaries are negligible transactions, and accordingly, in accordance with Article 64(3)(d)(1) of the Securities Regulations (Preparing annual financial statements), 5753-1993 ("the Regulations"), they are not described in these financial statements.

With regard to the State of Israel as a party with an interest in the Company – prior to Amendment of the Regulations – Securities Regulations (Preparing annual financial statements) (Amendment), 5766-2005, since the description of transactions in connection with regular provision of the Services involved many difficulties (these were a range of services to the State and its many branches, including Government ministries, state companies, and government authorities and companies), the Company was exempted from describing them. Now, in view of the aforesaid amendment to the Regulations, a general description is provided of the transactions, their characteristics and scope, in accordance with Article 64(3)(d)(2) of the Regulations.

(1) The services involved are the Services defined above.

(2) The consideration for most of the transactions which the Company has with State authorities are paid at tariffs set in the Regulations. The other transactions carried out by the Company with the State, (i.e. those for which the consideration is not paid at those tariffs), such as for services for which the regulations do not set a tariff, custom-ordered work, contract work, excavation and installation, and maintenance of transmitters, as well as transactions carried out by the Company's consolidated companies with the State authorities – all these are transactions in the normal course of business at market prices, and each individual transaction or service, of itself, is not material for the Company.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

A. (Contd.)

(3) For details of the transactions with government ministries, see section F below.

Arrangements which are not in compliance with these terms are disclosed separately in the financial statements.

B. Most of the Companies in the Group are required to pay royalties to the Government of Israel. Commencing January 2001, the income base requiring the payment of royalties was broadened, concurrently with a gradual reduction in the rate of the royalties, until a uniform rate was arrived at for all communications operators. In August 2006, an amendment to the royalties regulations was published, which regulates the reduction of 0.5% per year in their rate for all the licensees required to pay them, commencing January 1, 2006, until a rate of 1% per year is reached in 2010. The Ministry of Communications also gave notice that it will work for amendment of the regulations so that the Company will be exempted retroactively, from January 2004, from the duty to pay royalties in respect of revenues from services which have been opened to competition. A draft regulation was distributed in March 2007.

In the matter of the dispute between the Company and the Ministry of Communications relating to royalties in respect of revenues from interconnect from cellular subscribers to Company subscribers, the Company reached agreement with the Ministry to end past disputes relating to royalties up to and including 2002, except for two negligible revenue components. Under this agreement, the Company paid approximately NIS 17 million to the Ministry of Communications. In the past, the Company's financial statements included a provision for royalties, which, in light of the agreement with the Ministry of Communications, is over-provided. Accordingly, expenses for royalties to the Government of Israel were reduced in 2006 by approximately NIS 36 million, and the financing expenses in respect of royalties were reduced by approximately NIS 31 million. A provision remains in the financial statements in respect of possible disputes commencing 2003, which the Company's Management deems appropriate.

C. On August 1, 2004, a temporary order came into force, whereby for a period of two years or until a gap of up to 1.05 billion traffic minutes opens up between the Company's network and the network of another national domestic operator (except for a special license-holder and the Company), whichever is earlier, interconnect fees will not be paid for terminating a call between domestic operators, as noted. The Company receives compensation for non-payment of interconnect fees, by means of a reduction in the royalties it pays to the Government. That compensation will be up to NIS 40 million. This arrangement ended on November 25, 2006. The Ministry of Communications intends to extend this arrangement for 9 months, in a different format of setting off the royalties which HOT owes the State. The Company has expressed its opposition to the arrangement, and to the best of its knowledge, no amendment to the royalties regulations has yet been brought before the Knesset Finance Committee.

D. On May 8, 2005, a new commercial agreement was signed between the Company and the Ministry of Defence on behalf of the State of Israel, for the provision of communication services by the Company. The agreement was approved beforehand by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and required, since the Company was at that time under government control, the approval of the general meeting of the shareholders of the Company (by a special majority), as required by the Security regulations (Transactions between a company and its controlling shareholder), 5761-2001. Approval of the agreement was delayed due to the request of the Ministry of Communications and the Antitrust Commissioner for the Company's remarks on the questions they had raised. On August 23, 2006, the Company received a letter from the Antitrust Authority to the legal representative of the Ministry of Defence and the IDF, in which the Authority gave notice that the agreement does not contravene the provisions of the Antitrust Law, 5748-1988, and that the Authority sees no justification, at the present time, for insisting on cancellation of the agreement. The Company forwarded a copy of the letter to the Ministry of Communications. Based on the contents of the letter, the agreement came into force and the parties operate in accordance with it. The financial statements include the revenue according to the new agreement. However, the Ministry of Communications believes that the agreement includes discounts which the Company is not authorised to grant, and that it was signed for too long a term.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

D. (Contd.)

On March 27, 2007, the Ministry demanded (following an earlier request on December 4, 2006), that the agreement be amended so as not to violate the provisions of the law and of the Company's license. On March 28, 2007, the Company requested the response of the Ministry of Defence to the letter of the Ministry of Communications, and has not yet formulated its position on the matter.

On December 16, 2003, the Company filed a claim in the Tel Aviv District Court against the Ministry of Defence, for payment of approximately NIS 57 million in connection with a dispute on the matter of a discount of 18% which the Ministry of Defence deducted as noted above in section (3), and on March 16, 2004, the State filed its defence. On May 17, 2004, the Company filed a response. At the suggestion of the court, the parties agreed to refer the case to mediation proceedings, but subsequently decided to try to resolve their differences of opinion out of court. In April 2005, a settlement agreement was signed, which was approved by the Audit Committee of the Board of Directors and by the Board of Directors. The general meeting of the shareholders of the Company approved the agreement on June 2, 2005, as required by the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. In June 2005, the settlement agreement was approved by the court and validated as a court decision.

Below are the main points of the settlement agreement:

(1) For settlement of a financial claim for approximately NIS 37.4 million (principal) plus interest at an estimated amount of approximately NIS 20 million, filed by the Company against the State in the matter of deduction of discounts of 18% on various charges included under the "miscellaneous" item in the telephone bills of the IDF, the Ministry of Defence will pay the Company a total sum of NIS 28.5 million (including VAT where applicable), in three equal payments of NIS 9.5 million each, which will be paid by the following dates: June 30, 2005, January 31, 2006, and June 30, 2006.

(2) Arrears of one of the payments will require the Ministry of Defence to pay Accountant General's arrearage interest.

(3) Subject to the above, neither party will have any allegation and/or demand and/or claim against the other in this matter.

As a result of the settlement agreement, the Company cancelled a provision of approximately NIS 15 million.

E. On March 23, 2006, the general meeting of the shareholders of the Company approved the Company's entering into an agreement with a corporation owned and controlled by the shareholders of Ap.Sb.Ar., whereby the Company will be granted regular management and consultation services, including by means of currently-serving and future directors of the Company and/or its subsidiaries, in consideration of US $1.2 million per year. The term of the agreement is from October 11, 2005 (the date on which Ap.Sb.Ar. purchased 30% of the shares of the Company), and ends on December 31, 2008, unless one of the parties notifies the other of its wish to terminate the agreement by giving three months' notice.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

F. Transaction with interested parties and related parties

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Sales of products and services		
Telephony services –		
From the State of Israel	**368,487**	423,653
Others	**3,267**	2,563
Expenses –		
State of Israel –		
Royalties	**180,941**	257,445
Frequencies	**29,342**	30,762
Others (mainly purchase of satellite segments)	**124,256**	115,979

		For the year ended December 31	
		2006	2006
	Interest rate	NIS thousands	NIS thousands
Balances with related parties – Loans and long-term debts of interested parties			
Loans and debts – index-linked, without date to maturity	0%	**872**	5,514

For other balances with related parties, see relevant notes

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

G. Benefits to directors and the CEO

	For the year ended December 31	
	2006	**2005**
	NIS thousands	**NIS thousands**
Total cost of salary of the CEO and the Chairman of the Board *	**10,986**	8,025
Bonus to manager **	**2,400**	-
Number of employees	**2**	3
Compensation for members of the Board of Directors who are not Company employees***	**167**	1,643
Number of directors receiving compensation***	**2**	8
Remuneration of employee-directors****	**1,010**	653
Number of directors receiving the remuneration	**2**	1
Management fees to a controlling company*****	**5,000**	1,250

* The cost for 2005 includes salary and bonuses for the term of office of the CEO of the Company as CEO of Pelephone , as well as salary and months of early notice for the outgoing CEO, and salary and retirement compensation for the outgoing Chairman of the Board. The salary includes options which were distributed to the outgoing CEO and the outgoing Chairman, according to the employee stock options plan as described in an outline dated November 15, 2005.

** Following an enquiry by the Securities Authority on the subject of the bonus to senior employees, the bonus to the CEO was cancelled. See Note 35.

*** From the date of transfer of control in the Company to Ap.Sb.Ar., the directors serving on the Board of Directors of the Company, except for the external directors, do not receive compensation from the Company.

**** Salary paid to employee-directors for their work in the Company, and they receive no additional payment for their service as directors in the Company, over and above the options allocated to them – see Note 26.

***** A provision of NIS 5 million in respect of payment of management fees to Ap.Sb.Ar. – see section E above.

(1) On December 3, 2003, the general meeting of the shareholders of the Company approved a commitment to indemnify officers of the Company in the matter of the framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State pursuant to the framework agreement. The commitment was limited to NIS 890 million (the amount of capital raised), linked to the Consumer Price Index published after completion of raising the capital in accordance with the framework agreement.

(2) On May 13, 2004, the general meeting of the shareholders of the Company approved a commitment to officers in the matter of indemnity and insurance, as follows:

a. An obligation of the Company regarding the provision of a loan to officers to financing reasonable litigation expenses in legal proceedings, and an undertaking of the Company to purchase insurance policies for officers at reasonable cost.

b. Provision of indemnification letters in advance to officers of the Company in the following matters:

(1) A claim of a shareholder who held 15% or more of the share capital of the Company. The total amount of indemnity will not exceed $150 million, plus $30 million for legal expenses (a claim of this kind was excluded under the officers' insurance policies of the Company).

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

G. Benefits to directors and the CEO (contd.)

(2) In all matters relating to a prospectus for an offer for sale of securities of the Company by the State of Israel and an offering by the Company, which was published at the end of May 2004. The total amount of the indemnity (including undertakings to indemnify in advance which was given through publication of the prospectus and for an undertaking to indemnify in advance which will be given, if given, immediately prior to the transfer of control in the Company by the State), will not exceed 25% of the shareholders' equity of the Company (according to the 2003 financial statements, linked to the November 2003 Index).

(3) On April 20, 2004, the Board of Directors of the Company resolved that the Company will indemnify the employees of the Group who participated in the preparation of the prospectus that was intended to be published in May 2004, and who are not officers of the Company, for a financial liability which will be imposed upon them and for reasonable litigation expenses they would incur, regarding all matters relating to the prospectus, in the format of the indemnification letter which was given to the officers.

(4) On April 6, 2005, the general meeting of the shareholders approved an indemnification commitment in respect of a financial liability that would be imposed on officers of the Company and in respect of reasonable litigation expenses which they would incur, related directly or indirectly, to a proceeding for the sale of the State's holdings in the Company.
The indemnification commitment will be provided to officers who served and/or were appointed and/or will be appointed by the Company, commencing from the start of the Company's preparations for the sale proceeding and until the date of the closing of the sale proceeding.

The total amount of the indemnification will not exceed 25% of the shareholders' equity of the Company (according to the 2004 financial statements, linked to the November 2004 Index), including in respect of undertakings to indemnify in advance which were provided through the date of issuance of the letter of indemnification, together with an undertaking to indemnify in advance in accordance with the letter of the Minister of Finance dated April 21, 2004, which will be given, if given, immediately prior to transfer of the controlling interest in the Company by the State.

(5) On May 16, 2005, the general meeting of the shareholders approved the insurance of the officers of the Company, as follows:

Approval of the exercise of an option to purchase a run-off policy for the officers liability to the Company, with the terms of the current policy, with the following changes:

a. For a period of seven years from the date of the closing of the transfer of the State's shares in the Company which are being sold pursuant to the decision of the Ministerial Committee for Privatisation Affairs on July 19, 2004 ("the Sale Closing Date").
b. The total amount of the insurance cover will not exceed $150 million, plus $30 million in respect of legal expenses in Israel only.
c. Limits of liability:
    (1) Cover for the first 3 years at a limited liability of $150 million, plus $30 million in respect of legal expenses in Israel only.
    (2) Cover for an additional 3 years at a limited liability of $75 million, plus $15 million in respect of legal expenses in Israel only.
    (3) Cover for the seventh year at a limited liability of $25 million, plus $5 million in respect of legal expenses in Israel only.

    It should be noted that there is one limited liability for each run-off policy.
d. The premium for the entire period of insurance - $3 million (in a one-time advance payment).

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

G. (Contd.)

(6) The same general meeting on May 16, 2005 approved grant of an undertaking in advance to indemnify the officers of the Company who were serving with the Company at the time the indemnification commitment was provided, which will apply on the Sale Closing Date, or who served during the seven years prior to that date, due to a financial liability that would be imposed upon that person, in each of the events listed in the documents of indemnification and on the terms set out therein, where the officer acted in good faith and had reasonable grounds for assuming that the action is in the best interests of the Company. The to indemnification commitment will not apply regarding an event for which an insurer acknowledged liability under an insurance policy, but if the officer was charged, due to an indemnifiable event, with a sum exceeding the amount paid to him by the insurer, the Company will indemnify him with the difference, and subject to the amount of the indemnity for all the officers in the Company not exceeding $150 million plus $30 million in respect of legal expenses in Israel only per claim, and in total for a year of insurance in the period of insurance. Upon closing the transaction of sale of the State's shares to the Ap.Sb.Ar (October 11, 2005), this undertaking comes into force.

The resolutions noted in sections 4, 5 and 6 above will be applied from the Closing Date (October 11, 2005).

(7) On August 3, 2005, the special general meeting of the shareholders of the Company approved the extension of the term of the officers' insurance policy, including a run-off option, for a period of up to 4 months, at a cost of $112,500 per month, commencing July 31, 2005 (the date of expiry of the prior insurance policy). Upon closing the transaction for the sale of the State's shares to Ap.Sb.Ar. (October 11, 2005), the run-off option was exercised and that policy expired.

(8) On November 24. 2005 the general meeting of the shareholders approved the purchase of an insurance policy for officers in the Company for a period of one year commencing October 11, 2005, with a limit of liability of $150 million per claim and for the each year insured, plus $30 million per claim and for a total of all the claims for the period of insurance, in respect of legal expenses in Israel only. The limit of liability for subsidiaries – $50 million (as part of the aforementioned limit of liability). Annual premium – $675,000 + 1.5% stamp duty (it is noted that the scope of the insurance cover is the same as the officers insurance which prevailed until then in the Company, while the annual premium is considerably lower than the premium paid in the past, in view of the run-off insurance paralleling this insurance).

In addition, the general meeting approved a "framework transaction" for the Company's engagement, during the normal course of business, in future insurance policies (after expiry of the current policy referred to above), to cover directors and officers liability, as may be from time to time, including directors and officers who are or are likely to be considered controlling shareholders in the Company, and all by way of a "framework transaction" as defined in the Companies Regulations (Reliefs in transactions with interested parties), 5760-2000, at an annual premium of $675,000 plus a sum constituting up to 20% of that premium in respect of the amount of the insurance cover existing today (and noted above), as well as $30 million per claim and for all the claims in the period of insurance in respect of legal expenses in Israel only. Limit of liability for subsidiaries - $50 million (as part of the aforementioned limit of liability). If an amount of insurance cover is purchased which differs from the amount existing today, the option to increase the premium is up to a ceiling of 20% of the amount of the premium of the present policy ($675,000), i.e. the maximum premium (after the increase) will not exceed, in any case, US $810,000.

(9) On January 17, 2007, the general meeting of the Company approved making a commitment to indemnify the officers in the Company in accordance with a note of indemnity, for any liability or expense imposed on the officer due to his actions in his capacity as an officer in the Company (including his actions in subsidiaries), within the limitations provided in the Companies Law. The total amount of the indemnity was limited to a ceiling of 25% of the shareholders' equity of the Company as may be at the time of actually paying the indemnity. The note of indemnity will apply to types of events listed in an addendum to the note.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

H. Ap.Sb.Ar., which holds 30% of the shares of the Company, notified the Company that it is considering granting special remuneration to the former CEO of the Company, as a gesture for his contribution to the Company. The special remuneration, if decided upon, will be paid entirely by Ap.Sb.Ar. Under accounting principles, an appropriate expense will be recorded in the Company's books even though the Company is not bearing the payment. The expense that will be recorded, if and when the remuneration is paid, is not expected to be material for the Company.

I. On May 15, 2006, the Audit Committee of the Board of Directors and the Board of Directors approved the terms of employment of the Chairman of the Board, and on June 21, 2006 the terms were approved by the general meeting. Below are the main points of the terms of his employment:

a. The employment is an 80% position under a personal employment agreement, at a monthly salary of NIS 150,000 plus the standard incidentals (senior employees insurance, study fund, car and driver, expenses account, telephone, etc.).
b. In addition to the regular monthly salary, a payment once a year (with no strings attached), of NIS 1.2 million (linked to the CPI).
c. The commitment will be for an undefined period, where each party is entitled to bring it to an end by giving three months' notice.
d. If the Company introduces a stock options plan, the Chairman will be included in it on the basis of the provisions of the plan.

J. On August 14, 2006, the Board of Directors of the Company approved the sale of a property of the Company to the CEO of the Company (through a company he controls), in consideration of $630,000 plus VAT. The price was set according to the valuation of an external appraiser and after no higher offer was received from others.

K. For guarantees to related parties, see Note 19.

NOTE 30 – FINANCIAL INSTRUMENTS

Exposure to credit, interest rate and currency risks arises in the normal course of the Group's business. Derivative financial instruments are used by the Group to hedge exposure to fluctuations in foreign exchange rates and interest rates.

Credit risk
Management has a credit policy in place and the exposure to credit risks is monitored on a regular basis. Credit evaluations are performed by the Group on all customers requiring credit over a certain amount. The Group requires collateral in respect of financial assets.

The Group invests in marketable liquid securities of the Government and of companies with an investment rating. Transactions involving derivative financial instruments are made with companies which have a high credit rating.

The Group's Management regularly monitors customer debts, and the financial statements include provisions for doubtful debts which properly reflect, in Management's estimation, the loss inherent in debts whose collection is in question.

At the balance sheet date, there are no significant concentrations of credit risk. The maximum exposure to credit risk is represented by the carrying value of each financial asset, including derivative financial instruments, in the balance sheet.

Interest rate risk
The Group is exposed to changes in the fair value as a result of investments in debentures bearing fixed interest and as a result of credit it receives at fixed interest. The Group is exposed to movements in cash flows as a result of investments in debentures bearing variable interest and as a result of credit it receives bearing variable interest. The Group's investments in shares and amounts receivable and payable in the short-term, do not expose it to an interest rate risk.

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Effective interest rates and maturity dates/movements in interest rates

The table below shows the book values of a group of financial instruments which are exposed to fair value risk and/or cash flow risk in respect of interest rate, according to the earlier of the contractual dates of maturity or dates of repricing.

		2006								
		Average effective interest rate	Total	At least 6 months	6-12 months	1-2 years	2-3 years	3-4 years	4-5 years	Over five years
	Note	%	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000
Fixed-interest instruments										
Long-term trade receivables	6	7.55%	831,623	230,021	212,950	278,063	103,249	4,660	2,680	-
Long-term receivables	6	5.25%	157,269	73,574	55,203	25,502	2,990	-	-	-
Deposit regarding provision of loans to employees	7	5.56%	185,291	40,332	31,483	38,508	21,062	14,226	8,536	31,144
Long-term loan	7	6.40%	22,291	1,013	1,01 4	2,026	2,026	2,026	2,026	12,160
Investments in capital notes	7	5.85%	15,497	-	-	-	-	-	-	15,497
Loans from banks and others –										
CPI-linked shekel	13	6.2%	(1,528,390)	(776,026)	(102,353)	(161,732)	(75,557)	(66,045)	(62,387)	(284,290)
Debentures –										
CPI-linked shekel	13	5.0%	(3,502,969)	(307,090)	(56,817)	(631,738)	(623,991)	(623,052)	(866,228)	(394,053)
Euro, fixed		6.5%	(1,628,733)	-	(1,628,733)	-	-	-	-	-
			(5,448,121)	(738,176)	(1,487,253)	(449,371)	(570,221)	668,185	(915,373)	(619,542)
Variable-interest instruments	7									
Structured instruments		7.29%	60,361	-	60,361	-	-	-	-	-
Short-term deposit		4.00%	3,242	3,242						
Loans from banks and others –	13									
Short-term borrowing, unlinked shekel		6.90%	(118,330)	(118,330)	-	-	-	-	-	-
Unlinked shekel		7.40%	(647,999)	(647,999)	-	-	-	-	-	-
Debentures –										
Euro-linked shekel	13	4.70%	(30,379)	-	-	(30,379)	-	-	-	-
			(733,105)	(763,087)	60,381	(30,379)	-	-	-	-
Loans provided by a minority in a consolidated company	13	12.00%	(564,250)	-	-	-	-	-	-	(564,250)

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

		2005								
		Average effective interest rate	Total	At least 6 months	6-12 months	1-2 years	2-3 years	3-4 years	4-5 years	Over five years
	Note	%	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000	NIS-000
Fixed-interest instruments										
Long-term trade receivables	6	7.02%	751,230	194,693	196,637	243,551	112,967	1,883	1,499	-
Deposit for providing loans to employees	7	5.84%	192,621	42,328	33,414	41,040	21,742	14,589	8,754	30,754
Long-term loan	7	6.40%	24,388	1,016	1,016	2,032	2,032	2,032	2,032	14,228
Investments in capital notes	7	5.81%	56,990	-	-	-	-	-	-	56,990
Debentures available for sale	7	4.00%	78,547	78,547	-	-	-	-	-	-
Loans from banks and others –										
CPI-linked shekel	13	5.9%	(1,878,202)	(899,992)	(156,947)	(231,310)	((112,551)	(111,114)	(101,568)	(264,720)
Unlinked shekel		7.2%	(79,728)	(79,728)	-	-	-	-	-	-
In foreign currency shekel/dollar		4.0%	(230,150)	(230,150)	-	-	-	-	-	-
Debentures –	13									
CPI-linked shekel		5.0%	(3,760,243)	(434,683)	(55,603)	(131,239)	(635,723)	(625,421)	(624,482)	(1,253,092)
Euro, fixed		6.5%	(1,591,647)	-	-	(1,591,647)	-	-	-	-
			(6,436,194)	(1,327,969)	18,517	(1,667,573)	(611,533)	(718,031)	(713,765)	(1,415,840)
Variable-interest instruments	7									
Structured instruments		4.54%	65,597	-	-	65,597	-	-	-	-
Short-term deposit		4.00%	3,123	3,123	-	-	-	-	-	-
Loans from banks and others –	13									
Short-term borrowing, unlinked shekel		7.2%	(75,184)	(75,184)	-	-	-	-	-	-
Unlinked shekel		7.4%	(662,597)	(662,597)	-	-	-	-	-	-
Dollar, fixed		5.6%	(563,867)	(69,045)	(460,300)	(34,522)	-	-	-	-
Debentures –	13									
Unlinked shekel		4.5%	(36,423)	(36,423)	-	-	-	-	-	-
Euro-linked shekel		3.8%	(29,736)	-	-	-	(29,736)	-	-	-
			(1,299,087)	(840,126)	(460,300)	31,075	(29,736)	-	-	-
Loans provided by a minority in a consolidated company	13	12.00%	(505,280)	-	-	-	-	-	-	(505,280)

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Foreign currency risk
The Group is exposed to foreign currency risks on sales, purchases and borrowings denominated in currencies which are not the functional currency of the Group. The risks relate primarily to the Index, the US dollar and the euro.

Forecast transactions
The Company's policy is to reduce the exposure to changes in the foreign currency market and consumer price index in order to prevent losses from this exposure. The Company has future currency contracts for hedging forecast transactions. These transactions do not meet the criteria for hedging for accounting purposes, and therefore the change in the fair value is recognised directly to profit and loss.

Recognised assets and liabilities
At December 31, 2006, the fair value of forward exchange contracts that hedge economically financial assets and liabilities denominated in foreign currencies, represents surplus liabilities of approximately NIS 37,547 thousand (2005 – NIS 70,543 thousand) and is presented in the derivatives item.

The fair value at December 31, 2006 of forward Index contracts on the index, used for economic hedging of monetary assets and liabilities linked to the Index, is surplus liabilities of approximately NIS 13,675 thousand (2005 – NIS 16 thousand).

The Group has monetary assets that include, among others, cash and cash equivalents, trade receivables and debit balances, and financial liabilities that include, among others, trade payables, service providers and other payables and credit balances. Due to the nature of these monetary assets, their fair value corresponds to or is close to the value at which they are stated in the financial statements.

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Fair value

The following table shows the differences in respect of the book value and the fair value of groups of financial instruments, where there is a significant difference between them. The fair value of the long-term loans provided by the minority in a consolidated company is close to their value in accounts, since these loans bear interest at a rate close to the accepted market interest rate.

		2006		2005	
		Book value	Fair value	Book value	Fair value
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Loan provided	7	**22,291**	**24,887**	24,388	25,789
Investment in capital notes	7	**15,497**	**16,254**	56,990	60,848
		37,788	**41,141**	81,378	86,637
Unrecognised profit			**3,350**		5,259
Short-term borrowing	13	**118,330**	**118,330**	75,184	75,184
Secured bank loans	13				
Dollar-linked					
CPI-linked		**-**	**-**	563,867	569,483
Foreign currency shekel/dollar		**1,528,390**	**1,450,661**	1,878,202	1,887,505
Unlinked		**-**	**-**	230,150	233,687
		647,999	**647,999**	742,325	742,818
Debentures issued to the public	13				
CPI-linked		**1,704,322**	**1,761,732**	1,714,244	1,763,531
Denominated in euro		**1,628,733**	**1,691,478**	1,591,647	1,733,622
Unlinked		**-**	**-**	36,423	36,564
Debentures issued to financial institutions and others	13				
CPI-linked		**1,798,647**	**1,828,986**	2,045,999	2,121,520
Euro-linked		**30,379**	**32,567**	29,736	30,381
		7,456,800	**7,531,753**	8,907,777	9,194,295
Unrecognised loss			**74,953**		286,518

Estimation of fair values

The methods used to estimate the fair values of financial instruments are described in Note 4.

Interest rates applied in the determination of fair value

	2006	2005
	%	%
Long-term trade receivables	**7.6**	7.0
Loans and receivables	**5.6**	6.4
Loans	**6.4**	5.3
Debentures	**4.4**	4.0
Deposit for loans for employees	**5.0**	5.7

NOTE 31 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY

Balance sheet

	2006	2005
	NIS thousands	NIS thousands
Assets		
Cash and cash equivalents	**2,262,037**	1,679,244
Trade receivables	**856,797**	897,416
Other receivables	**214,335**	283,059
Inventory	**13,000**	7,000
Other investments, including derivatives	**957,222**	2,050,789
Current tax assets	**-**	7,128
Total current assets	**4,303,391**	4,924,636
Investments and loans, including derivatives	**355,873**	397,877
Property, plant and equipment	**4,244,841**	4,728,521
Intangible assets	**230,038**	270,830
Deferred and other expenses	**220,734**	230,301
Investments in investees accounted by the cost method	**5,973,124**	5,669,953
Deferred tax assets	**739,197**	625,560
Total non-current assets	**11,763,807**	11,923,042
Total assets	**16,067,198**	16,847,678

NOTE 31 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

Balance sheet (Contd.)

	2006	2005
	NIS thousands	NIS thousands
Liabilities		
Loans and borrowings	**1,877,040**	942,229
Trade payables	**393,757**	540,459
Other payables, including derivatives	**605,033**	631,654
Current tax liabilities	**78,440**	-
Provisions	**207,759**	195,652
Employee benefits	**863,406**	680,169
Proposed dividend	**300,000**	-
Total current liabilities	**4,325,435**	2,990,163
Debentures	**4,381,322**	6,002,528
Obligations to banks	**-**	34,522
Other long-term liabilities	**27,081**	16,151
Employee benefits	**335,544**	373,945
Total non-current liabilities	**4,743,947**	6,427,146
Total liabilities	**9,069,382**	9,417,309
Equity		
Share capital	**6,309,133**	6,309,133
Share premium	**1,623,423**	1,623,423
Reserves	**669,791**	389,246
Deficit	**(1,604,531)**	(891,433)
Total equity	**6,997,816**	7,430,369
Total equity and liabilities	**16,067,198**	16,847,678

NOTE 31 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

Statement of income

	2006	2005
	NIS thousands	NIS thousands
Income	**5,798,996**	**5,892,953**
Costs and expenses		
General and operating expenses	**3,723,898**	3,825,998
Depreciation	**1,026,469**	1,109,385
Other expenses (income), net	**228,893**	(97,143)
Royalties	**66,269**	135,575
	5,045,529	4,973,815
Operating income	**753,467**	919,138
Financing expenses (income), net	**(368,504)**	85,633
Profit after financing	**1,121,971**	833,505
Other income	**(320,000)**	(49,792)
Profit before income tax	**1,441,971**	883,297
Income tax	**253,883**	375,361
Earnings for the year	**1,188,088**	507,936

NOTE 31 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

Statement of changes in shareholders' equity

	Share capital	Share premium	Capital reserve in respect of a transaction between a corporation and a controlling shareholder	Capital reserve in respect of assets available for sale	Capital reserve in respect of option warrants to employees	Retained earnings	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance as January 1, 2005	6,309,133	1,623,423	37,775	70,265	-	(1,386,659)	6,653,937
Profits for the year	-	-	-	-	-	507,936	507,936
Change in the fair value of financial assets available for sale, less tax	-	-	-	1,386	-	-	1,386
Profits from financial assets available for sale attributable to profit and loss, less tax	-	-	-	(67,089)	-	-	(67,089)
Actuarial gains and losses in a defined benefit plan, less tax	-	-	-	-	-	(12,710)	(12,710)
Payment from the State to employees in respect of Company privatisation	-	-	1,235	-	-	-	1,235
Share-based payments to Company employees from its shareholders	-	-	345,674	-	-	-	345,674
Balance as at December 31, 2005	6,309,133	1,623,423	384,684	4,562	-	(891,433)	7,430,369
Changes for 2006							
Profits for the year	**-**	**-**	**-**	**-**	**-**	**1,188,088**	**1,188,088**
Change in the fair value of financial assets available for sale, less tax	**-**	**-**	**-**	**(2,361)**	**-**	**-**	**(2,361)**
Profits from financial assets available for sale attributable to profit and loss, less tax	**-**	**-**	**-**	**(3,600)**	**-**	**-**	**(3,600)**
Actuarial gains and losses in a defined benefit plan, less tax	**-**	**-**	**-**	**-**	**-**	**(1,186)**	**(1,186)**
Dividends to shareholders	**-**	**-**	**-**	**-**	**-**	**(1,900,000)**	**(1,900,000)**
Share-based payments	**-**	**-**	**-**	**-**	**286,506**	**-**	**286,506**
Balance as at December 31, 2006	**6,309,133**	**1,623,423**	**384,684**	**(1,399)**	**286,506**	**(1,604,531)**	**6,997,816**

NOTE 31 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

Statement of cash flows

	2006	2005
	NIS thousands	NIS thousands
Cash flows from operating activities		
Net earnings	**1,188,088**	507,936
Adjustments to earnings	**1,459,675**	1,981,385
Net cash from operating activities	**2,647,763**	2,489,321
Cash flows stemming from (used for) investment activities	**629,858**	(1,371,310)
Cash flows used for financing activities	**(2,699,963)**	(767,905)
Net increase in cash and cash equivalents	**577,658**	350,106
Cash and cash equivalents as at January 1	**1,679,244**	1,327,731
Effect of fluctuations in the rate of exchange on cash balances	**5,135**	1,407
Cash and cash equivalents as at December 31	**2,262,037**	1,679,244

Appendix of non-cash operations

	2006	2005
Acquisition of property, plant and equipment, other assets, materials and spare parts on credit	**72,074**	120,023
Sale of property, plant and equipment on credit	**161,800**	-

NOTE 32 – GROUP ENTITIES

Significant subsidiaries

	Country of registration	Rate of ownership For the year ended December 31, 2006	2005
Pelephone Communications Ltd. (1)	Israel	**100**	**100**
Bezeq International Ltd. (2) (4)	Israel	**100**	100
D.B.S. Satellite Services (1998) Ltd. (3)	Israel	**49.8**	49.8
BezeqCall Communications Ltd. (4)	Israel	**100**	100
Bezeq On Line Ltd. (5)	Israel	**100**	100
Bezeq Zahav (Holdings) Ltd. (6)	Israel	**100**	100
Stage One (7)	Israel	**83**	100
Goldnet Communication Services – registered partnership (8)	Israel	**100**	74.9

(1) Pelephone Communications Ltd. ("Pelephone") is a wholly-owned subsidiary of the Company. Pelephone provides cellular services, and sells and repairs terminal equipment.

Pelephone operates under an operating license of the Ministry of Communications – a general license for cellular services ("the License"). The License, in its updated form, was received on February 7, 1996 for a period of 10 years from its commencement date of January 1, 1994, with an option for extension for another 6 years ("the Additional Period") and for renewal for an additional one or more periods of 6 years beyond the Additional Period.

In the framework of winning an additional band of frequencies in December 2001, Pelephone's License was extended to 2022.

(2) Bezeq International Ltd. ("Bezeq International") is wholly-owned by the Company, and was established on April 5, 1995 to engage in international communications, in accordance with a Government decision dated December 28, 1994 and following a change in the general license of the Company. Since 1999, Bezeq International has also been providing internet access services. Bezeq International has holdings in the Walla! Communications Group Ltd. (see Note 12).

(3) D.B.S. Satellite Services (1998) Ltd. ("DBS") was incorporated in Israel on December 2, 1998. In January 1999, DBS received a license from the Ministry of Communications to transmit satellite television broadcasts in Israel ("the License"). The License was granted for a period of ten years from the date of its receipt, and could be extended under certain conditions for an additional six years. In June 2002, the term of the License was extended for five additional years beyond the first term.

In July 2000, DBS ended the preparation stage and began to provide its customers with multi-channel television broadcasts in accordance with the License granted pursuant to the Communications Law.

Since commencing operations, DBS has accumulated considerable losses. DBS's losses in 2006 and 2005 amounted to approximately NIS 320 million and NIS 346 million, respectively. As a result of these losses, its capital deficit and its working capital deficit at December 31, 2006 amounted to approximately NIS 2,861 million and NIS 1,551 million respectively.

The Company's investment in DBS (primarily in shareholder loans) at the balance sheet date amount to approximately NIS 1,562 million (without interest and linkage). The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 131 million. This debt has not yet been repaid in full, and the Company recently came to an arrangement with DBS for its collection, whereby the past debt will be paid in 60 equal monthly instalments plus interest at prime + 1.5%.

During 2005, the banks completed the provision of the entire credit facility to which DBS was entitled under the financing agreements.

NOTE 32 – GROUP ENTITIES (CONTD.)

Significant subsidiaries (Contd.)

(3) (Contd.)
The terms of the loans and the credit facility which DBS received from the banks, the balance of which at December 31, 2006 was NIS 1,394 million, impose various restrictions on DBS which include, *inter alia*, restrictions on the encumbrance or sale of certain assets, a restriction on receipt of credit from other banks without prior approval, a restriction concerning repayment of shareholder loans, and a requirement for compliance with financial criteria ("the Conditions").

At December 31, 2006, DBS is in compliance the Conditions laid down in the financing agreements (after a relief granted in connection with the financial criteria in respect of the fourth quarter of 2006), but the Management of DBS does not expect that it will be in compliance with the Conditions in 2007 and thereafter. In view of this forecast, the bank loans are stated as part of current liabilities. DBS approached the banks for amendment and adjustment of the maturity dates for full repayment of the bank credit. At the date of approval of the financial statements, these terms have not yet been agreed.

Following decisions of Ministers of Communications during 2004 and 2005, which limit injections to DBS by the Company, on February 17, 2005, the Board of Directors of the Company resolved that it stands behind its resolution of March 30, 2004 to continue investing in DBS according to the approved work plan, together with other shareholders and financing entities. This resolution was based, among others, on an external legal opinion that the Minister of Communications does not have the authority to prohibit injections of funds by the Company to DBS.

During April and May 2005, the Company and DBS filed petitions in the High Court of Justice for an order *nisi* against the then Minister of Communications, according to which the aforementioned decisions of the Ministry of Communications are void *ab initio*. The petitions, which were heard on October 11, 2005, raise questions of principle which are far from simple, both factually and legally, and which were brought into sharp focus during the hearing. The ruling of the High Court has not yet been handed down, and the Company, relying on its legal advisers, is unable to assess the probability of the petitions' success. It is noted that at the same time as the proceeding, the Ministry of Communications gave notice of his intention to call in NIS 10 million out of the Company's guarantee. On July 7, 2005, the Company, in accordance with its right under the general license, filed an appeal against the Ministry's decision to call in the guarantee.

On March 21, 2006, the Company received a letter from the Minister of Communications, which stated that subsequent to examining the implications of the continued injections of funds to DBS, in order to advance and consolidate competition in fixed-line domestic communications, and based on the business plan of DBS for 2006, which was presented to the Minister, he was considering limiting the injection of funds to DBS in 2006 in the following manner:

1. The Company's part in the total injections of funds to DBS would not exceed 40%.
2. The other shareholders' part in DBS and of the banks or institutional financing entities in the injections, would not be less than 60%.
3. The Company or an entity acting on its behalf, would not provide a guarantee for the shareholders, the banks or the institutional financing entities, or any other similar commitment, to secure their part in the injections or credit granted to DBS by them.
4. Towards the end of 2006, the matter of the injections would be re-examined, to the extent required in the following years.

The Company notified the Minister of Communications that there was neither place nor justification for such restrictions, and requested a hearing before the Minister. At the date of publication of the financial statements, the Company has not been invited to put its position to the Minister.

For DBS's non-compliance with payment arrangement with suppliers, see Note 18(3).

NOTE 32 – GROUP ENTITIES (CONTD.)

Significant subsidiaries (Contd.)

(3) (Contd.)

On January 2, 2005, the Antitrust Commissioner gave his conditional approval for a merger of the Company and DBS (increasing the holdings of the Company in DBS to more than 50%). The merger was not realised. With the elapse of a year from the date of the approval, a new consent is required. On August 2, 2006, the Company and DBS submitted new merger notices to the Antitrust Commissioner, in the matter of exercise of options for shares in DBS by the Company, which would increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Authority gave notice of the Commissioner's opposition to the merger, and on February 18, 2007 it gave the reasons for the opposition. The Company intends to appeal the decision.

On December 24, 2006, the board of directors of DBS approved the budget for 2007. According to this budget, in 2007 DBS will require additional external financing. At the date of approval of the financial statements, DBS is working to obtain additional sources of finance that will enable it to attain the budget targets for the coming year. If those sources cannot be found, DBS will operate in accordance with an alternative business plan which does not necessitate financial resources beyond those available to it. The Management of DBS estimates, based on the 2007 budget and on the alternative business plan, that it is more likely than not that the sources of financing required by DBS in the coming year can be arranged.

(4) Bezeqcall Communications Ltd. ("Bezeqcall"), is a wholly-owned subsidiary of the Company. Bezeqcall commenced operations in 1995 and operates principally in the network end point market, access networks and providing total communication solutions. On August 23, 2006, Bezeq International and Bezeqcall signed a merger agreement, whereby upon fulfilment of the suspending conditions provided in the agreement, the parties would merge so that all the operations of Bezeqcall, including all its assets and liabilities, would transfer as is to Bezeq International, commencing January 1, 2007. The approval of the Antitrust Commissioner for the merger was received on October 5, 2006, and on December 31, 2006 the Ministry of Communications approved assignment of Bezeqcall's network end point license to Bezeq International. On February 11, 2007, the Registrar of Companies confirmed that in accordance with the provisions of Section 323 of the Companies Law, 5759-1999 ("the Law"), Bezeq International had absorbed Bezeqcall and that from that date, Bezeqcall no longer existed.

On October 15, 2006, an agreement was signed between Bezeqcall and Tadiran – Telecom Communication Services in Israel – a limited partnership ("Tadiran"), concerning the acquisition of all the operations of Tadiran for a consideration of approximately NIS 93 million (subject to certain adjustments depending on the date of closing the transaction). The closing in respect of the transaction is subject to receipt of approvals, including from the Antitrust Commissioner. In March 2007, the Company learned that the Commissioner does not approve the transaction. Bezeq International and Tadiran are considering their actions in the matter.

(5) Bezeq On Line Ltd. ("Bezeq On Line") was established in December 2000 and commenced operations in 2001. Bezeq On Line provides call centre outsourcing services.

(6) Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav") is wholly-owned and controlled by the Company. Bezeq Zahav was established in September 1995 and commenced operations in May 2004. Bezeq Zahav holds debentures issued by the Company.

(7) This is a venture capital fund in which the management rights are held by the SOCI, and the Company has rights in the profits – see Note 3A(2).

(8) On April 30, 2006, an agreement was signed between the Company and Malam Systems Ltd., who are partners in Goldnet Communication Services ("Goldnet") – a registered partnership, which provides solutions for the secure electronic distribution and transfer of information between organizations and the subsidiary Bezeq International. Under the agreement, Bezeq International acquired all the operations of Goldnet.

NOTE 32 – GROUP ENTITIES (CONTD.)

Significant subsidiaries (Contd.)

(8) (Contd.)

After compliance with all the suspending conditions set out in the acquisition agreement, in July 2006 Goldnet, which operated under the commercial name of Bezeq Zahav, ceased to provide services and its operation merged into Bezeq International.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION

As stated in Note 2A, these are the Group's first consolidated financial statements prepared in accordance with IFRS.

The accounting policies set out in Note 3 have been applied in preparing the financial statements for the year ended December 31, 2006, the comparative information in the financial statements for the year ended December 31, 2005, and in the preparation of an IFRS opening balance sheet at January 1, 2005 (the Group's date of transition to IFRS).

In preparing its IFRS opening balance sheet, the Group has adjusted amounts reported previously in financial statements prepared in accordance with its old basis of accounting (Israeli GAAP).

An explanation of how the transition from Israeli GAAP to IFRS has affected the Group's financial position, financial performance and cash flows, is set out in the following tables and in the notes that accompany them.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Reconciliation of equity

	Note	Israeli GAAP	Effect of transition to IFRS	IFRS	Israeli GAAP	Effect of transition to IFRS	IFRS
			January 1, 2005			December 31, 2005	
		NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets							
Cash and cash equivalents		1,457,107	-	1,457,107	2,158,773	-	2,158,773
Trade receivables	R	2,115,070	1,600	2,116,670	2,113,512	1,370	2,114,882
Other receivables	E, R	416,113	(287,947)	128,166	321,507	(179,650)	141,857
Inventory	R	314,549	12,322	326,871	220,404	10,880	231,284
Broadcasting rights		140,496	-	140,496	154,500	-	154,500
Other investments, including derivatives	I	1,287,809	177,949	1,465,758	2,398,525	4,888	2,403,413
Current tax assets	R	-	13,224	13,224	-	18,134	18,134
Total current assets		5,731,144	(82,852)	5,648,292	7,367,221	(144,378)	7,222,843
Materials and spare parts	R	130,922	(130,922)	-	88,881	(88,881)	-
Trade and other receivables		302,079	-	302,079	361,013	-	361,013
Investments and loans, including derivatives	J, P	570,496	58,322	628,818	405,827	50,894	456,721
Property, plant and equipment	A-E, G, R	*10,522,971	(2,958,667)	7,564,304	*9,762,307	(2,515,810)	7,246,497
Intangible assets	D and H	2,180,562	471,638	2,652,200	2,080,029	531,005	2,611,034
Deferred expenses	E, R	-	391,895	391,895	-	391,738	391,738
Investments in associates accounted for by the equity method	P	70,308	(55,649)	14,659	75,467	(55,099)	20,368
Deferred tax assets	A-C, I-N	*516,395	774,153	1,290,548	*398,742	678,882	1,077,624
Total non-current assets		14,293,733	(1,449,230)	12,844,503	13,172,266	(1,007,271)	12,164,995
Total assets		20,024,877	(1,532,082)	18,492,795	20,539,487	(1,151,649)	19,387,838

* Restated – see section (u) below.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Reconciliation of equity (Contd.)

	Note	Israeli GAAP	Effect of transition to IFRS	IFRS	Israeli GAAP	Effect of transition to IFRS	IFRS
		January 1, 2005			December 31, 2005		
		NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current liabilities							
Loans and borrowings	O	1,633,499	-	1,633,499	1,864,941	1,295,711	3,160,652
Trade payables	E	1,790,569*	(4,067)	1,786,502	1,514,714*	33,743	1,548,457
Other payables, including derivatives	I, J, M, R	1,287,140*	(348,540)	938,600	1,273,955*	(354,630)	919,325
Provisions	R	-	249,769	249,769	-	259,811	259,811
Employee benefits	M	602,474	135,260	737,734	577,878	139,845	717,723
Total current liabilities		5,313,682	32,422	5,346,104	5,231,488	1,374,480	6,605,968
Liabilities							
Debentures	R	3,824,539	(13,434)	3,811,105	4,903,056	(11,716)	4,891,340
Obligations to banks	O	2,860,934	-	2,860,934	2,151,960	(1,403,907)	748,053
Loans from others		47,375	(8,786)	38,589	34,081	99,162	133,243
Loans provided by the minority in a subsidiary	Q	1,057,988	(601,558)	456,430	1,114,498	(609,218)	505,280
Less – minority interest in deficit of a subsidiary	Q	(1,057,988)	1,057,988	-	(1,114,498)	1,114,498	-
Employee benefits	M	814,096	(45,812)	768,284	431,427	(35,074)	396,353
Provisions		-	52,427	52,427	-	52,359	52,359
Minority rights	R	(10,412)	10,412	-	-	-	-
Total non-current liabilities		7,536,532	451,237	7,987,769	7,520,524	(793,896)	6,726,628
Total liabilities		12,850,214	483,659	13,333,873	12,752,012	580,584	13,332,596
Equity							
Share capital		6,309,133	-	6,309,133	6,309,133	-	6,309,133
Share premium		1,623,423	-	1,623,423	1,623,423	-	1,623,423
Reserves	I	37,775	72,004	109,779	39,010	350,927	389,937
Dividend proposed subsequent to the balance sheet date		-	-	-	1,200,000	(1,200,000)	-
Retained earnings (deficit)	A-C, F, G-J, M	(795,668)**	(1,620,903)	(2,416,571)	(1,384,091)**	(377,880)	(1,761,971)
Total equity attributable to equity holders of the Company		7,174,663	(1,548,899)	5,625,764	7,787,475	(1,226,953)	6,560,522
Minority interest	G	-	(466,842)	(466,842)	-	(505,280)	(505,280)
Total equity		7,174,663	(2,015,741)	5,158,922	7,787,475	(1,732,233)	6,055,242
Total equity and liabilities		20,024,877	(1,532,082)	18,492,795	20,539,487	(1,151,649)	19,387,838

* Restated.
** Restated – see section (u) below.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity

The impact on deferred tax of the adjustments described below, is set out in section (s) below.

a. At the transition date, the Group chose to state some of the property, plant and equipment items (the switching, transmission and power group) at their fair value and to determine that value as deemed cost, in accordance with the relief under IFRS 1. The deemed cost was based on an external expert opinion. As a result, the property, plant and equipment balances decreased by NIS 1,782 million at January 1, 2005 (NIS 1,415 million at December 31, 2005), to a fair value of approximately NIS 2,124 million at January 1, 2005, while the deferred tax balances deriving from the differences in the measurement of the property, plant and equipment for tax purposes changed compared with the presentation of property, plant and equipment for accounting purposes, by approximately NIS 540 million and NIS 401 million at January 1, 2005 and December 31, 2005 respectively. The reserve balances were reduced on those dates by the respective net amounts. The depreciation expense for 2005 decreased by NIS 365 million.

b. On the date of transition to IFRS, in accordance with the directives of IAS 16, the residual value of the property, plant and equipment not included in the calculation of depreciation according to accepted accounting principles in Israel was measured. The effect was to increase the property, plant and equipment balances and to reduce the depreciation expense for 2005 by approximately NIS 32 million. Another effect was to change the deferred tax balances derived from the differences in the measurement of the property, plant and equipment for tax purposes as compared with the presentation of property, plant and equipment for accounting purposes. In addition, the reserves' balances were reduced by the same amount at the above dates.

c. Under IAS 37, the Group is required to recognise liabilities to bear the costs of site decommissioning and clearing. Under IFRS 1, the expected costs of decommissioning and clearing sites at the transition date. As a result, the reserve balance by approximately NIS 17 million (net of tax). The balance of the property, plant and equipment at January 1, 2005 and at December 31, 2005 increased by NIS 19 million and NIS 18 million respectively.

d. Under IFRS, computer software and capitalised software development costs which are not an integral part of the hardware attributed to them, are treated as intangible assets. Accordingly, with the transition to IFRS, the carrying balances at January 1, 2005 and at December 31, 2005, of NIS 546 million and NIS 516 million respectively, relating to computer software and to capitalised software development costs, were reclassified from the property, plant and equipment item to the intangible assets item.

e. Under accepted accounting principles in Israel, agreements granting the Group an indefeasible right of use of sea-bed cable capacity was treated as a finance lease and an asset relating to them was recognised in the balance sheet within the property, plant and equipment account. Under IFRS and as provided in IFRIC 4, which determine whether an arrangement includes a lease, there are criteria for determining whether a right to use an asset is an arrangement having the form of a lease. If it is not a lease, the arrangement should be classified as an arrangement for receipt of services. The effect of application of the provisions of IFRIC 4 and in the absence of the criteria required for the transactions to be defined as having the form of a lease, the amounts paid to the suppliers for a future right of use of sea-bed cable capacity were classified as deferred and other long-term expenses.

   The effect of the transition to IFRS is to decrease property, plant and equipment by approximately NIS 187 million and approximately NIS 171 million at January 1, 2005 and December 31, 2005 respectively, to decrease trade and service provider payables by approximately NIS 21 million at January 1, 2005, against an increase in the following items:
   (1) Other accounts receivable (prepaid expenses) of approximately NIS 19 million and approximately NIS 17 million at January 1, 2005 and December 31, 2005 respectively.
   (2) Other long-term assets (long-term prepaid expenses in respect of a right of use of capacity), of approximately NIS 147 million and NIS 154 million respectively.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

f. Under accepted accounting principles in Israel, the Group recognised as an asset the net direct costs paid to a third party in respect of sale to subscribers who signed a commitment to remain customers of the Group. These costs included the commissions paid to external dealers. In addition, the costs of subsidising the terminal equipment for customers were recognised as assets ("Subscriber Acquisition"). This Subscriber Acquisition was depreciated to profit and loss over the term of the customer commitment, which is up to 36 months.

   Under IAS 38, the Group capitalises the incremental direct sales commissions to employees and to external dealers in respect of sales to those subscribers who signed a commitment to remain customers of the Group. These costs are depreciated to profit and loss over the term of the commitment of the subscribers, which is up to 36 installments. As a result, the reserve balance at January 1, 2005 and at December 31, 2005, was reduced by approximately NIS 46 million (net of tax).

g. Under accepted accounting principles in Israel, customer acquisition costs in a consolidated company were partially capitalised to property, plant and equipment and depreciated over 6 years, and part was charged as a current expense to profit and loss. Under IFRS, these costs were capitalised and depreciated over the terms of the contractual engagement of the subscriber, which are usually one year.

   The difference between the accumulated depreciation under accepted accounting principles in Israel and the accumulated depreciation under IFRS at January 1, 2005 and at December 31, 2005, amounts to NIS 330 million and NIS 295 million respectively.

h. The Group has chosen the relief in IFRS 1, whereby it will apply the provisions of IFRS 3 only in respect of business combinations that occurred after January 1, 2005 (the date of transition to IFRS). Accordingly, commencing January 1, 2005, under IFRS principles, the Group ceased amortisation of goodwill.

   As a result, an increase of approximately NIS 94 million was recorded in the intangible assets item at December 31, 2005, and a corresponding decrease in the other expenses (income), net, item at the same date.

i. Unlike accepted accounting principles in Israel, under the IFRS, financial instruments are classified as available for sale, and all the derivative financial instruments are recognised assets or as liabilities at their fair value.

   The effect of the transition to IFRS on January 1, 2005, is an increase in other investments, including derivatives, of approximately NIS 100 million; in other investments, including short-term derivatives, of approximately NIS 3 million; in other payables, including derivatives, of approximately NIS 11 million; in surpluses of approximately NIS 6 million (net of tax), and in a capital reserve in respect of assets available for sale, of approximately NIS 72 million. The effect at December 31, 2005, is a decrease of approximately NIS 3 million in investments and loans, including non-current derivatives, a decrease in other payables, including derivatives, of approximately NIS 3 million, a decrease of approximately NIS 16 million in financing expenses for 2005, a decrease of approximately NIS 3 million in reserve balances, and an increase of approximately NIS 5 million in a capital fund in respect of assets available for sale.

j. Under IAS 39, the Group separated embedded derivatives from the host contract and stated them at fair value. The effect of transition to IFRS at January 1, 2005 is an increase of approximately NIS 2 million in non-current investments, an increase of approximately NIS 2.5 million in liabilities, and an increase of approximately NIS 2.5 million (net of tax) in reserve balances. The effect of the transition to IFRS at December 31, 2005 is an increase of approximately NIS 11 million in liabilities, an increase of approximately NIS 15 million in financing expenses, and a reduction of approximately NIS 4 million to the tax expense.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

Receivables in respect of derivative financial instruments of approximately NIS 77 million at January 1, 2005 and of approximately NIS 5 million at December 31, 2005, were reclassified from the other receivables item to the other investments including short-term derivatives item.

k. Under IFRS, deferred tax assets are classified as non-current assets, even if the expected date of their realisation is expected to be in the short term. Under accepted accounting principles in Israel, deferred tax assets were classified as current or non-current assets, depending on the classification of the assets in respect of which they were generated.
Accordingly, with the transition to IFRS, the balance of short-term deferred taxes was reclassified, at January 1, 2005 and at December 31, 2005, amounting to approximately NIS 234 million and approximately NIS 194 million respectively, from the accounts receivable and debit balances item under current assets, to the deferred tax item under non-current assets.

l. Under accepted accounting principles in Israel, the transition to Standard 19 was effected by way of cumulative effect at the beginning of 2005. The effect of transition to IFRS was by way of amendment of reserves at January 1, 2005 in the amount of approximately NIS 15 million.

m. Under accepted accounting principles in Israel, severance pay liabilities were recognised on the basis of the full liability, assuming that all the employees would be terminated on terms entitling them to full compensation, irrespective of capitalisation rates, future salary increment rates and future cessation of employment. In addition, liabilities in respect of vacation and sick leave were calculated on the basis of estimated utilisation and redemption, respectively. On the date of transition to IFRS, all the net liabilities for service benefits after retirement and other long-term benefit plans are measured in accordance with IAS 19, and the difference of approximately NIS 14 million and approximately NIS 4 million at January 1, 2005 and at December 31, 2005 respectively, was credited to reserves (net of tax).

The effect of the transition to IFRS for 2005 is to reduce the liability for service benefits by NIS 21 and NIS 7 million at January 1, 2005 and at December 31, 2005 respectively, to decrease salary expenses by NIS 17 million, to increase financing expenses by NIS 15 million, and to charge actuarial losses of NIS 11 million to surpluses (net of tax) for the year ended December 31, 2005.

The liabilities in respect of vacation, amounting to NIS 110 million at January 1, 2005 and December 31, 2005, were reclassified from the other payables including derivatives item, to the short-term employee benefits item.

The liabilities in respect of sick leave, amounting to NIS 47 million at January 1, 2005 and NIS 55 million at December 31, 2005, were reclassified from the long-term employee benefits item, to the short-term employee benefits item.

n. The Group has applied IFRS 2 for share-based payments made after January 1, 2005. The Group has granted equity-settled share-based payments in 2005 and 2006.

Under accepted accounting principles in Israel, principles similar to those of IFRS 2 were applied only for grants made subsequent to March 15, 2005, provided they vested not before January 1, 2006.

The effect of measuring equity-settled share-based payments at fair value is to increase the salary expense by approximately NIS 346 million for the year ended December 31, 2005. The adoption of IFRS 2 is equity-neutral for equity-settled transactions. The expense recognised for employee services given in consideration of share options granted, will be deductible for tax purposes when the share options are exercised, limited to the amount of the benefit according to income tax rules.

o. Under IFRS, bank loans in a consolidated company were stated as short-term loans, while under accepted accounting principles in Israel these loans were classified as long-term loans. The change in classification was made since the consolidated company failed to meet financial criteria set by the banks for those loans on the balance sheet date.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

p. Under IFRS, the Group consolidated its investments in a Special Purpose Entity (SPE), since that entity, which is controlled by the Group was established on terms which impose severe limitations on the decision-making powers of the SPE's management, in contrast to the accepted accounting principles in Israel, under which the investment was stated as an investment in an investee company, since the Group does not control it the entity. The effect is a decrease the investments in investees accounted by the equity method and an increase mainly in investments and loans, including derivatives, amounting to approximately NIS 56 million at January 1, 2005 and NIS 55 million at December 31, 2005. In addition, the Company's equity in the losses of an investee decreased by approximately NIS 9 million, with a corresponding increase in the financing expenses in 2005.

q. Under accepted accounting principles in Israel, the minority item in the Company is measured at the amount of the loans provided by the minority for DBS, a consolidated company, at their carrying value in the investee company, and stated net of those loans.

Under IFRS, the minority rights are stated in the consolidated balance sheet as a separate component of the shareholders' equity, in the amount of the loans provided by the minority for a consolidated company at their fair value, plus the costs of financing in respect of those loans, accumulated from the acquisition date to the balance sheet date. The minority equity in the capital deficit of the consolidated company is stated under distribution of earnings between the majority shareholders and the minority shareholders.

r. Other classifications made in accordance with IFRS:

1. Leases of land from Israel Lands Administration classified as operating leases, of approximately NIS 233 at January 1, 2005 and of approximately NIS 221 at December 31, 2005, were transferred from the property, plant and equipment item to the deferred expenses item.
2. Materials and spare parts which were stated in a separate item between the current assets item and the property, plant and equipment item, were reclassified to the inventories item and the property, plant and equipment item amounting to NIS 12 and NIS 11 respectively, at January 1, 2005 and to NIS 11 and NIS 78, respectively, at December 31, 2005.
3. Current tax liabilities of approximately NIS 13 at January 1, 2005 and of approximately NIS 18 at December 31, 2005, were transferred from the other payables item to a separate item in the Group's balance sheet.
4. Prepaid expenses for rentals of approximately NIS 8 at January 1, 2005 and of approximately NIS 7 at December 31, 2005, were reclassified from the other assets and deferred expenses item to the deferred expenses item.
5. Provisions amounting to approximately NIS 250 at January 1, 2005 and approximately NIS 260 at December 31, 2005, were reclassified from the other payables including derivatives item to a separate item in the Group's balance sheet.
6. Other income, net, was classified under other operating income, net.
7. The debentures are stated net of deferred issuance expenses of approximately NIS 13 million and NIS 12 million at January 1, 2005 and December 31, 2005 respectively.
8. The Group made additional adjustments which are not material.

s. The above changes increased (decreased) the deferred tax liability (asset) as follows:

		January 1, 2005	December 31, 2005
	Note	NIS thousands	NIS thousands
Property, plant and equipment	A-C	561,538	399,573
Intangible assets	F	31,307	27,723
Financial instruments	I-J	(36,909)	2,166
Employee benefits	M	(6,249)	(2,780)
Share-based payments	N	-	64,255
Increase in deferred tax assets		549,687	490,937

The effect of the transition to IFRS on the income statement for the year ended December 31, 2005, was to increase the tax expense reported in the past in respect of the period, by NIS 100 million.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

t. Effect of the above adjustments on shareholders' equity:

	Note	January 1, 2005 NIS thousands	December 31, 2005 NIS thousands
Property, plant and equipment	A, B, C, G	(2,145,302)	(1,714,751)
Intangible assets	F - J	(68,032)	30,665
Financial instruments	I, J	(15,946)	(21,436)
Employee benefits	M	19,740	6,938
Share-based payments to employees in the Company	N	-	(345,674)
Others		1,850	(24,752)
Deferred taxes	S	586,787	491,130
Total adjustment of reserve balances		(1,620,903)	(1,577,880)
Financial assets available for sale		109,104	5,446
Share-based payments to employees in the Company		-	345,674
Deferred taxes	S	(37,100)	(193)
Total adjustment of funds and capital		72,004	350,927
Attributed to:			
Holders of the Company's capital		(1,548,899)	(1,226,953)
Minority rights		(466,842)	(505,280)
		(2,015,741)	(1,732,233)

u. **Restatement**

The financial statements at the date of transition, at December 31, 2005 and for the year ended December 31, 2005, were adjusted by way of restatement in order to retroactively reflect the following changes:

(1) Recording a reduction in lease payments of land from Israel Lands Administration over the term of the lease and not as reduced since the establishment of the Company (4%). The effect of this amendment will be the addition of approximately NIS 100 million and NIS 105 million to property, plant and equipment, and of approximately NIS 75 million and NIS 80 million to the balance of shareholders' equity at December 31, 2004 and 2005 respectively. The amendment does not significantly affect the profit for the year.

(2) Statement of receipts from interconnect to the cellular networks, which were not stated commencing 2000, as part of the Company's revenue and correspondingly as an operating expense in the same amount, following examination of the criteria under international standards and in order to present them as accepted in Israel and worldwide. The affect of this amendment is an increase to income and a corresponding increase to operating and general expenses of approximately NIS 828 million.

(3) Amendment of the accounting treatment of the amortisation of property, plant and equipment not used by Pelephone, and the resulting tax implications. The effect of this amendment is to reduce property, plant and equipment by approximately NIS 320 million and NIS 285 million, and to reduce the balance of shareholders' equity by approximately NIS 220 million and NIS 205 million at December 31, 2004 and 2005 respectively, as well as to reduce depreciation expenses by approximately NIS 32 million and to increase net profit by approximately NIS 17 million for 2005.

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

u. **Restatement (Contd.)**

(1) Effect on the consolidated balance sheet under accepted accounting principles in Israel at December 31, 2005

	As previously reported	Effects of restatement	As reported in these financial statements
	NIS thousand	NIS thousand	NIS thousand
Property, plant and equipment	9,942,648	(180,341)	9,762,307
Deferred tax assets	344,786	53,956	398,742
Shareholders' equity	7,913,860	(126,385)	7,787,475

(2) Effect on the consolidated balance sheet under accepted accounting principles in Israel at January 1, 2005

	As previously reported	Effects of restatement	As reported in these financial statements
	NIS thousand	NIS thousand	NIS thousand
Property, plant and equipment	10,740,334	(217,363)	10,522,971
Deferred tax assets	446,136	70,259	516,395
Shareholders' equity	7,321,767	(147,104)	7,174,663

(3) Effect on undesignated retained earnings (deficit) under accepted accounting principles in Israel

	As at December 31 2005	As at December 31 2004
	NIS thousand	NIS thousand
As previously reported	(1,257,706)	(648,564)
Effect of restatement	(126,385)	(147,104)
	(1,384,091)	(795,668)

(4) Effect on profit and loss under accepted accounting principles in Israel

	For the year ended December 31, 2005
	NIS thousand
Net earnings as reported in the past	590,858
Effect of restatement	
Increase in income	828,000
Decrease in depreciation expenses and reductions	37,022
Increase in operating and general expenses	(828,000)
Increase in income tax	(16,303)
Net earnings as reported in these financial statements in the note on adjustment to IFRS	611,577

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

Reconciliation of profit for 2005

	Note	Israeli GAAP 2005	Effect of the transition to IFRS 2005	IFRS 2005
		NIS thousands	NIS thousands	NIS thousands
Income	r	11,926,686(2)	(1,968)	11,924,718
Costs and expenses				
Depreciation and amortization	a-c, f-h	2,377,813(1)(2)	(444,036)	1,933,777
Salaries	m, n	2,260,352(1)	325,428	2,585,780
Operating and general expenses	f, g	5,934,421(1)(2)	43,645	5,978,066
Other operating income, net	r	-	(99,841)	(99,841)
		10,572,586	(174,804)	10,397,782
Operating income		1,354,100	172,836	1,526,936
Financing costs	l, j, m, p			
Financing expenses		773,783	(36,224)	737,559
Financing income		(465,860)	99,599	(366,261)
Financing expenses, net		307,923	63,375	371,298
Earnings after financing expenses		1,046,177	109,461	1,155,638
Equity in loss of investees accounted by the equity method	p	(12,645)	9,325	(3,320)
Earnings before income tax		1,033,532	118,786	1,152,318
Income tax	a-c, j	445,897(2)	86,118	532,015
Earnings before cumulative effect of a change in accounting method		587,635	32,668	620,303
Cumulative effect at the beginning of the year of a change in accounting method	l	15,000	(15,000)	-
Earnings for the year		602,635	17,668	620,303
Attributable to:				
Shareholders of the Company		611,577	54,834	666,411
Minority in a consolidated company	q	(8,942)	(37,166)	(46,108)
Earnings for the year		602,635	17,668	620,303
Earnings per share				
Basic and diluted earnings per share (in NIS)		0.231	0.007	0.238

(1) Reclassified
(2) Restated

NOTE 33 – TRANSITION TO INTERNATIONAL STANDARDS (IFRS) – EXPLANATION (CONTD.)

Notes to the reconciliation of equity (Contd.)

Explanation of significant adjustments to the statement of cash flows for 2005

1. The effects of fluctuations in the exchange rates of cash balances in the amount of NIS 3 million were classified as cash flows from current operations under Israeli GAAP. Under IFRS, the effects of exchange rate fluctuations on cash balances are presented in a separate item.

   There are no other significant differences between the statement of cash flows according to IFRS and the statement of cash flows according to Israeli GAAP.

2. Interest paid in the amount of approximately NIS 485 million was classified as cash flows from current operations under accepting accounting principles in Israel. Under IFRS, interest paid was classified as cash flows from financing activities.

3. Following the transition to IFRS and the treatment of subscriber acquisition costs as intangible assets, as noted in section (f) of the details presented above, the investment in intangible assets under cash flow from investment activities decreased by approximately NIS 72 million, against an increase in the current expenses included under cash flow from current operations.

4. Following the transition to IFRS and the treatment of customer acquisition costs in a consolidated company, as noted in section (g) of the details presented above, the investment in intangible assets under cash flows used for investment activities increased, against a decrease in the current expenses included under cash flow from current operations, of NIS 50 million.

NOTE 34 – SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD.

1. Pelephone Communications Ltd.

A. Balance sheet

	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Current assets	**1,451,006**	1,837,664
Non-current assets	**2,52 0,473**	2,877,169
	3,971,479	4,714,833
Current liabilities	**1,089,973**	1,572,159
Long-term liabilities	**1,383,859**	1,707,408
Total liabilities	**2,473,832**	3,279,567
Shareholders' equity	**1,497,647**	1,435,266
	3,971,479	4,714,833

B. Income statement

	For the year ended December 31,	
	2006	2005
	NIS thousands	NIS thousands
Revenues from services and sales	**4,477,987**	4,428,277
Cost of services and sales	**3,250,303**	3,301,475
Gross profit	**1,277,684**	1,126,802
Sales and marketing expenses	**417,178**	428,200
General and administrative expenses	**110,008**	107,218
	527,186	535,418
Operating income	**700,498**	591,384
Financing expenses, net	**(17,687)**	(123,630)
Equity in losses of investee partnership	**-**	(8,507)
Earnings before income tax	**682,811**	459,247
Income tax	**196,910**	172,369
Net earnings	**485,901**	286,878

NOTE 34 – SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. D.B.S. Satellite Services (1998) Ltd.

A. Balance sheet

	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Current assets	**338,662**	346,292
Non-current assets	**677,732**	757,903
	1,016,394	1,104,195
Current liabilities	**1,889,416**	1,946,780
Non-current liabilities	**1,987,634**	1,699,698
Total liabilities	**3,877,050**	3,646,478
Capital deficit	**(2,860,656)**	(2,542,283)
	1,016,394	1,104,195

B. Income statement

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Revenues	**1,355,735**	1,221,863
Cost of income	**1,139,308**	1,072,103
Gross profit	**216,427**	149,760
Sales and marketing expenses	**122,996**	141,588
General and administrative expenses	**94,313**	74,662
Operating loss	**(882)**	(66,490)
Financing expenses, net	**318,925**	279,455
Net loss	**(319,807)**	(345,945)

NOTE 34 – SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. Bezeq International Ltd.

A. Balance sheet

	December 31, 2006	December 31, 2005
	NIS thousands	NIS thousands
Current assets	**332,526**	367,285
Non-current assets	**340,734**	337,816
	673,260	705,101
Current liabilities	**307,724**	342,621
Non-current liabilities	**15,613**	13,536
Total liabilities	**323,337**	356,157
Shareholders' equity	**349,923**	348,944
	673,260	705,101

B. Income statement

	For the year ended December 31	
	2006	2005
	NIS thousands	NIS thousands
Revenues	**1,021,573**	814,926
Operating expenses	**662,244**	(529,738)
Gross profit	**359,329**	285,188
Sales and marketing expenses	**148,594**	135,736
General and administrative expenses	**71,806**	57,561
Other income (expenses), net	**7,064**	(1,377)
Operating income	**131,865**	93,268
Financing costs, net	**(6,965)**	(9,157)
Equity in earnings of an associate accounted for by the equity method	**11,051**	4,560
Earnings before income tax	**135,951**	88,671
Income tax (expenses) benefit	**(40,391)**	15,722
Net earnings	**95,560**	104,393

NOTE 35 – EVENT AFTER THE BALANCE SHEET DATE

1. Following an enquiry of the Securities Authority, it was decided to appoint an external examiner to investigate the matter of compensation for officers n the Company since the transfer of control in the Company from the State to Ap.Sb.Ar. Holdings Ltd. (including approval of the stock options plan for employees and managers, and approval of bonuses for officers), and to investigate the matter of restatement in the Group's financial statements at December 31, 2004 and 2005.

2. The Board of Directors of the Company acceded to the request of the CEO to take leave of absence until the date of submission of the interim findings by the examiner, in order to remove even the slightest suspicion regarding the complete freedom of action of the external examiner.

American Appraisal (UK) Limited

Aldermary House
10-15 Queen Street
London EC4N 1TX

Tel: 020 7778 0800
Fax: 020 7248 1453

Web site:
www.american-appraisal.co.uk

INTERNATIONAL VALUATION CONSULTANTS

REAL ESTATE APPRAISAL

PLANT AND MACHINERY APPRAISAL

FINANCIAL APPRAISAL

INVESTMENT RECOVERY GROUP

REAL ESTATE ADVISORY GROUP

Our Ref: IWG/IU3430

28 March 2007

The Directors
Bezeq" The Israel Telecommunications Corp. Limited
15 Hazvi Street, PO Box 1088
91010, Jerusalem
Israel

F.A.O. Dany Oz

Gentlemen

Re: Valuation of Network Assets

Further to your recent instructions, and as per the agreement signed by yourselves on 21st January 2007, American Appraisal (UK) Limited and BDO Consulting ("American Appraisal") have now completed our investigation and appraisal of certain client designated assets, exhibited to us as being the property of "Bezeq" The Israel Telecommunication Corp. Limited ("Bezeq" or "The Company" or "Client") and submit our findings in this draft appraisal report.

The assets comprised a quantity of client-specified equipment of various types, used within Bezeq's telephone network, and located throughout Israel.

This Summary Appraisal report presents discussions of the data, reasoning, and analyses used in the appraisal process to develop American Appraisal's opinions of value.

Our report comprises this letter, an executive summary, a narrative section, together with appendices.

If you have any questions regarding this report, please do not hesitate to contact me.

Yours faithfully

Ian W Gough
Managing Director, Industrial Valuation Group
For and on behalf of American Appraisal (UK) Ltd
28th March 2007

The Definitive Standard Worldwide

OVER 60 OFFICES THROUGHOUT NORTH AMERICA, SOUTH AMERICA, EUROPE, AFRICA AND THE FAR EAST

AMERICAN APPRAISAL (UK) LIMITED REG OFFICE: ALDERMARY HOUSE, 10-15 QUEEN STREET, LONDON, EC4N 1TX. REG NO 1549537. VAT NO 365 3128 57

BDO
ZIV HAFT
Consulting Group

Pini Shmeuli-Nisan
Partner, For and on behalf of
BDO Ziv Haft
Consulting & Management Ltd
28th March 2007

46-48 Menachem Begin road Tel-Aviv 66184 Israel ☎972-3-6386894🖷: 972-3-6382511

-

"Bezeq" The Israel Telecommunication Corp. Limited Switches Valuation 1 January 2005

[28 March 2007]

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C. Assumptions and Limiting Conditions

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American Appraisal (UK) Limited

Aldermary House
10-15 Queen Street
London EC4N 1TX

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Fax: 020 7248 1453

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Re: Valuation of Network Assets

Further to your recent instructions, American Appraisal (UK) Limited and BDO Consulting ("American Appraisal") have now completed our investigation and appraisal of certain client designated assets, exhibited to us as being the property of "Bezeq" The Israel Telecommunication Corp. Limited ("Bezeq" or "The Company" or "Client") and submit our findings in this draft appraisal report.

The assets comprised a quantity of client-specified equipment of various types, used within Bezeq's telephone network, and located throughout Israel.

This Summary Appraisal report presents discussions of the data, reasoning, and analyses used in the appraisal process to develop American Appraisal's opinions of value.

Our report comprises this letter, an executive summary, a narrative section, together with appendices.

If you have any questions regarding the content of this report, please do not hesitate to contact me.

Yours faithfully

Ian W Gough
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28th March 2007

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ZIV HAFT
Consulting Group

Pini Shmeuli-Nisan
Partner, For and on behalf of
BDO Ziv Haft
Consulting & Management Ltd
28th March 2007

1. Executive Summary

Purpose of Assignment

1.1 The purpose of our independent investigation was to provide our opinion of the fair value of the subject assets.

1.2 We understand that the intended use of the appraisal is for financial reporting purposes in accordance with International Financial Reporting Standards ("IFRS"), and most specifically, for determining deemed cost in accordance with International Financial Reporting Standard 1 ("IFRS 1").

1.3 In undertaking this appraisal, and preparing this report, American Appraisal was cognisant of the requirements under IFRS for the determination of an opinion of value to be subsequently used as a deemed cost. Specifically American Appraisal was aware of the requirements of International Accounting Standard 16, "Property, Plant and Equipment" ("IAS 16"), and has undertaken this valuation in accordance with those requirements.

Basis and Premise of Value

1.4 The basis of valuation required to be adopted was "Fair Value", defined in IAS 16 as:

"*the amount for which an asset could be exchanged, or a liability settled between knowledgeable willing parties in an arm's-length transaction."*

Valuation Date

1.5 The valuation was undertaken as at 1 January 2005.

Information

1.6 In the course of performing our valuations we have reviewed certain information, provided to us by Bezeq's management teams, which included, inter alia, lists of assets, accounting records, equipment quantities, and internal replacement cost studies. We have also had regard to publicly available industry information considered relevant to the activities undertaken by Bezeq.

Conclusion

1.7 Based upon the investigation described herein it is our opinion that, as of 1 January 2005, the Fair Value of the subject assets is reasonably represented in the amount of: **862,860,000** NIS (Eight hundred sixty two million, eight hundred sixty thousand NEW ISRAELI SHECKELS).

1.8 This report is prepared in accordance with, and subject to, our General Service Conditions and Assumptions and Limiting Conditions which form part of this letter.

1.9 Unless the facts and circumstance suggested otherwise, our opinion of Fair Value was prepared on the basis of continued use. Accordingly, we have assumed that the assets will continue to be used in the ongoing business of Bezeq, and this opinion of value does not represent the amount that might be realised from the piecemeal disposition of the assets in the open market.

1.10 Our opinion of Fair Value has been prepared under the assumption that the earnings of the operation in which the assets are utilised will be adequate to justify ownership of the assets appraised.

1.11 We have not investigated the title to, or any liabilities against, the property appraised and no responsibility is assumed for these matters.

1.12 We hereby certify that we have neither a present nor a prospective interest in the Company, the assets appraised or the value reported.

1.13 We confirm that our appointment was for a stand alone engagement, and does not form part of any ongoing relationship with Bezeq. We can confirm that we have not previously rendered valuation services to Bezeq.

1.14 Our fees for this engagement were based on the time required to provide our professional services and were in no way contingent upon the outcome of our conclusions.

1.15 Investigation and report by:

- Daniel D Zoller Jr, ASA

- Cynthia N White, ASA
- Ian W Gough, FRICS
- Pini Shmeuli Nissan
- Nir Peles

1.16 Professional assistance provided by:

- Kevin Phung
- Nick Goyal
- Erez Zahavi
- Hila Fisher

2. Introduction

Scope and Purpose

2.1 American Appraisal has been engaged by Bezeq to carry out an independent assessment of certain, client specified, network assets located within Israel.

2.2 The purpose of our independent investigation was to provide our opinion of the Fair Value of certain assets utilised in the Israeli telecommunications sector (the "Assets"), as specified by Bezeq.

2.3 We understand that the intended use of the appraisal is for financial reporting purposes in accordance with IFRS, and most specifically, for determining deemed cost in accordance with IFRS 1.

2.4 In undertaking this appraisal, and preparing this report, American Appraisal was cognisant of the requirements under IFRS for the determination of an opinion of value to be subsequently used as a deemed cost.

2.5 The basis of valuation required to be adopted was Fair Value, defined in IAS 16 as:

"*the amount for which an asset could be exchanged, or a liability settled between knowledgeable willing parties in an arm's-length transaction.*"

2.6 Unless the facts and circumstance suggested otherwise, our opinion of Fair Value was prepared on the basis of continued use. We have assumed that the assets will continue to be used in the ongoing business of Bezeq, and accordingly, this opinion of value does not represent the amount that might be realised from the piecemeal disposition of the assets in the open market.

2.7 Our opinion of Fair Value has been prepared under the assumption that the earnings of the operation in which the Assets are utilised will be adequate to justify ownership of the Assets appraised.

2.8 The details of the scope of our engagement and our terms and conditions are included in our engagement letter, a copy of which is available under separate cover to this report.

2.9 When Fair Value is established on the premise of continued use, it is assumed that the buyer and the seller would be contemplating retention of the assets at their present location as part of the current operations. An estimate of Fair Value arrived at on the premise of continued use does not represent the amount that might be realized from piecemeal disposition of the assets in the marketplace, or from an alternative use of the assets. The premise of continued use is generally appropriate when:

- The assets are fulfilling an economic demand for the service they provide.
- The assets have a remaining useful life expectancy.
- Responsible ownership and competent management may be expected.
- Diversion of the assets to an alternative use would not be economically feasible or legally permitted.
- Continuation of the existing use by present or similar users is practical.
- Functional utility of the assets for their present use is given due consideration.
- Economic utility of the assets is given due consideration.

2.10 We did not investigate any financial data pertaining to the present or prospective earning capacity of the operation in which the designated Assets are used. It was assumed that prospective earnings would provide a reasonable return on the appraised value of the designated Assets, plus the value of any assets not included in the appraisal, and adequate net working capital. If prospective earnings are not adequate to justify ownership of the Assets at the appraised levels, then the concluded Fair Value as reported here, must be reduced accordingly.

Valuation Date

2.11 The valuation was undertaken as at 1 January 2005.

The Property Appraised

2.12 Our investigation dealt with client-designated Assets contained in the "Bezeq switches1 6.02.07 AAA" Excel file, provided to us by Bezeq. This file contained details of assets to be appraised and comprised details of the asset categories and subcategories, quantities of assets and years of acquisition, together with the categories total cost, accumulated depreciation, and net book value. The categories and sub categories of assets appraised are described under section 8.8.

Appraisal Services Provided

2.13 Our services included:

- Review of available existing data
- Project planning
- Data gathering and interviews
- Sample asset inspections
- Correlation and valuation
- Valuation review
- Conclusion and reporting

Scope of Appraisal

2.14 During the course of our investigations we undertook a limited inspection of a sample of the Assets appraised. We did not, however, undertake a formal engineering survey of any of the subject Assets.

2.15 In the process of formulating our opinions of the costs, asset lives and market values, we held discussions with the Bezeq management team regarding the history and nature of the various Assets, the operation, capacities, network life and condition.

2.16 Details of the Assets appraised follow later in the report.

Sources of Information

2.17 In the course of performing our valuations we have reviewed certain information, provided to us by Bezeq's management teams, which included, inter alia, lists of assets, accounting records, equipment quantities, and internal replacement cost studies. We have also had regard to publicly available industry information considered relevant to the activities undertaken by Bezeq.

2.18 The principal information provided to us, and used in arriving at our valuation, is outlined in Appendix A.

Limitations

2.19 This document has been prepared solely for the directors of Bezeq for the purposes stated herein and should not be relied upon for any other purpose. However we do understand and accept that a copy of this report may be provided to Bezeq's advisors and auditors.

2.20 We understand and accept that a copy of this report will be provided to Bezeq's advisors and auditors and that they will rely on it solely when expressing their opinion on the company's financial statements with regards to the presentation of property, plant and equipment, according to IFRS.

2.21 American Appraisal understands that the valuation report, might be published as part of Bezeq's period report and, potentially, if Bezeq undergoes an IPO, or any other funding process in Israel or outside of Israel or shall publish a prospectus in Israel, or outside of Israel, the Valuation might be published as part of Bezeq's prospectus.

2.22 We draw your attention to the fact that we are not permitted or regulated to provide investment advice. Whether or not a particular party chooses to invest in Bezeq (or a related party thereof) involves many additional considerations outside the scope of this report. Any such decision is a matter for individual parties and their financial advisors.

2.23 While our work has involved an analysis of information and records received, our engagement does not include any work in the nature of an audit. Accordingly, we assume no responsibility and make no representations with respect to the accuracy or completeness of any information provided by and on behalf of Bezeq.

2.24 Our engagement has been limited to the valuation of the identified Assets. We have not valued any other assets and liabilities pertaining to Bezeq.

2.25 We have provided a draft copy of this report to Bezeq's management who have confirmed, to the best of their knowledge and belief, that the factual information contained within this document is correct and that there are no material omissions. We reserve the right to alter our conclusions should any information that we were not aware of at the time of preparing this report come to light, that has a material impact on the conclusions herein.

2.26 Our valuation has been prepared solely for the purpose defined and may not be used for any other purposes.

3. Assets Appraised

3.1 Our assignment comprised an appraisal of the value of certain client specified Assets, identified as the property of Bezeq.

Nature of the Business

3.2 In order to appraise the Assets within the context of their continuing use, we first considered the operation in which they were employed the operating environment in Israel and the nature of the assets. A summary of the data considered is presented in sections 3 to 7. The following, summary commentary is drawn from publicly available sources concerning the Bezeq operations.

3.3 Bezeq is Israel's national telecommunications provider. Established in 1984, the Company has led Israel into the new era of communications, based on the most advanced technologies and services. Bezeq and its subsidiaries offer the full range of telecommunication services, including domestic, international and cellular phone services; Internet, ADSL, and other data communications; leased lines, and corporate networks.

Assets Appraised

3.4 A listing of the appraised Assets that make up the Bezeq switching centres is provided below.

Switch num	Site num	Switch Name	Operation start date
95291	10858	Zomet hasharon1	30/6/1996
99421	10858	Zomet Asharon2	30/6/1996
92250	1002	Koresh Jer	30/6/1997
92263	1003	Merhavia	30/6/1998
92436	1004	Qiryat yovel1	30/6/1995
92437	1004	Qiryat yovel2	30/6/1996
90251	1005	Givat Shaul	30/6/1996
92380	1006	Romema	30/6/1996
90276	1007	Gilo	30/6/1996
90277	1007	Gilo **STP**	30/6/2006
92731	1008	Talpiot	30/6/1996
92790	1009	Golomb	30/6/1996
92274	1010	Hordus	30/6/1996

Switch num	Site num	Switch Name	Operation start date
92820	1011	Ramat eshcol	30/6/1996
92890	1012	Neve yacov	30/6/1995
90286	1013	Ramot	30/6/1998
93523	1014	Zafon	30/6/1996
93525	1015	Dafna	30/6/1996
93571	1017	Givhataiim	30/6/1996
93365	1020	Yaood	30/6/1997
93537	1021	Tahana Merkazit	30/6/1996
93516	1022	Yad Eliaoo	30/6/1995
93542	1023	Ramat Aviv	1/1/1997
90346	1024	Yarkon1	1/1/1997
93504	1024	Yarkon2	30/6/1996
93506	1024	Yarkon **STP**	30/6/2005
93677	1025	Dan	30/6/1996
93548	1026	Ramat hashron	30/6/1997
93566	1027	Mikve	30/6/1996
93567	1027	Mikve **STP**	1/1/2000
93510	1028	MaaravTA1	30/6/1996
93511	1028	MaaravTA2 Tan	30/6/2000
93672	1029	Ramat Gan	30/6/1996
93574	1030	Ramat Izhak	1/1/1997
93579	1031	Bene brak1	30/6/1996
93582	1031	Bene brak2	30/6/2000
93556	1032	Azur	30/6/1995
90381	1033	Darom	30/6/1996
90382	1033	Darom **STP**	30/6/2001
93503	1034	Holon	30/6/1996
93550	1035	Bat yam1	30/6/1998
93658	1035	Bat yam1b	
90421	1036	Mizrhch haifa	30/6/1997
94260	1037	Ahooza2	30/6/1996
94340	1037	Ahooza1	30/6/1997
94330	1038	Carmel tzarfati	30/6/1996
94500	1040	Marav haifa	30/6/1996
94501	1040	Marav haifa2	30/6/1997
90461	1042	Borg	30/6/1996
94731	1043	Motzkin	30/5/1995
90475	1045	Qiryat yam	30/6/1996
92101	1048	Bar cohova	30/6/1996
92102	1048	Bar cohova **STP**	
92539	1062	Maoz zion	30/6/1996
92912	1064	Bet shemesh	30/6/1997
93685	1073	KorshA	30/6/1995
93102	1085	Koresh G	30/6/2005
93561	1085	Koresh G DMS100	30/6/1995
93562	1085	Koresh G **STP**	30/6/1996
93531	1087	Or yehuda	30/6/1996
93541	1088	Tochnit L	30/6/1996
93551	1089	Bat yam ta'	30/6/1996
93552	1089	Bat yam ta' **STP**	

Switch num	Site num	Switch Name	Operation start date
93659	1089	Bat yam ta'2	
93721	1090	Rama	30/6/1996
93934	1091	Petach tikva1	1/1/1997
93921	1092	Petach tikva2	1/1/1997
93922	1092	Petach tikva2 tandem	30/6/1999
93932	1093	Oron	30/6/1997
93933	1093	Oron tandem	
93950	1094	Rashlaz2	30/6/1998
93963	1094	Rashlaz **STP**	
93964	1094	Rashlaz1	30/6/1996
93938	1097	Rosh hain	30/6/1996
93961	1098	Ramat elyahoo	30/6/1996
93973	1102	Ben-Guriun Airport	30/6/1996
94350	1106	Reches **STP**	30/6/1998
94360	1106	Reches2	30/6/1997
94370	1106	Reches1	30/6/1996
94411	1107	Mifraz2	30/6/1997
94821	1114	Naharia2	30/6/1998
94922	1116	Naharia1	30/6/1996
94831	1117	Qiryat tivon	30/6/1997
94950	1121	Kefar yasif	30/6/1995
94001	1122	Shikmona **STP**	30/6/1998
94002	1122	Shikmona	30/6/1998
94867	1122	Shfaram	30/6/1996
94972	1125	Maalot	30/6/1996
94881	1126	Carmiel	30/1/1900
94811	1127	Acco	30/6/1996
94891	1128	Yokneam	30/6/1996
97722	1131	Ashkelon migdal	30/6/1997
95176	1134	Afridar	30/6/1996
97880	1140	Qiryat gat1	30/6/1997
97881	1140	Qiryat gat2	30/6/2002
95231	1144	Kefar Saba	30/6/1996
95297	1151	Herzelia1	30/6/1996
95298	1151	Herzelia **STP**	30/6/2004
99951	1151	Herzrlia2	1/1/1999
95363	1157	Netania1	30/6/1996
99832	1157	Netania2	30/6/1996
95362	1158	Ezorim	30/6/1996
90985	1167	Kfar yona	30/6/1997
95561	1174	Ashdod1	1/1/1997
95559	1175	Ashdod2	30/6/1996
95581	1176	Qiryat malachi	30/6/1997
95746	1182	Sanhedrin	30/6/1996
95727	1184	Beer sheva1	30/6/1996
95727	1184	Beer sheva1 **STP**	1/1/1997
97290	1184	Beer sheva2	30/6/1996
95743	1197	Neot midbar **STP**	30/6/1996
95743	1197	Neot midbar	30/6/1997
95755	1200	Dimona	30/6/1996

Switch num	Site num	Switch Name	Operation start date
97971	1213	Arad	1/1/1998
97372	1217	Eilat1	30/6/1996
95931	1218	Eilat2	30/6/1996
96340	1221	Hadera1	30/6/2003
96341	1221	Hadera2	1/1/1997
96341	1221	Hadera2 **STP**	1/7/1997
96342	1221	Hadera3	30/6/2004
96377	1225	Pardes Hana	30/6/1996
96390	1228	Zicron Yacov	30/6/1998
96545	1234	Migdal Aemek	30/6/1996
96560	1235	Nzrat1	30/6/1995
96561	1235	Nzrat2	30/6/1996
96773	1246	Tveria elit	30/6/1995
96781	1247	Eilaboon	30/6/1998
96970	1254	Zefat	30/6/1998
96940	1256	Qirit Shemona	30/6/1997
98221	1263	Ayalon1	30/6/1996
98223	1263	Ayalon2	30/1/2000
98436	1266	Rehovot2	30/6/1996
98401	1267	Ness ziona	30/7/1997
98430	1269	Yavne	30/6/1996
96526	1446	Aafoola	1/1/1997
96526	1446	Aafoola **STP**	30/6/1997
96723	1451	Tveria Ta	30/6/1997
93528	1912	Nodia	1/1/1997
98209	1961	Modihin	1/1/2004
98410	2748	Oshiot	30/6/1996
90335	2945	Qirhon	30/6/1996
94210	2969	Nesher	30/6/1995
98270	3169	Reut	30/6/1997
99791	3723	Raanana1	1/1/1997
99792	3723	Raanana2 Tandem	30/6/1997
99793	3723	Raanana **STP**	30/6/2004
94844	8128	Qiryat ata	1/7/1997

4. Approach to Value

4.1 There are three generally accepted approaches to value, namely the cost, market and income approaches. The use of any one approach, or combination of approaches, is determined by the nature of the appraisal and the premise of value.

4.2 Before arriving at our opinions of value, we inspected a sample of assets at twenty-five Bezeq equipment sites. The assets at these sites accounted for approximately fifty percent of the overall Fair Value of the assets.

4.3 The theory of the three valuation approaches is outlined as follows:

Cost Approach

4.4 In the cost approach, value is established based on the cost of reproducing or replacing the asset, less depreciation from physical deterioration, and functional and economic/external obsolescence, if present and measurable.

(a) *Cost of reproduction new* is defined as the estimated amount required to reproduce a duplicate or replica of the asset at one time in like kind and materials in accordance with current market prices (as at 1 January 2005) for materials, labour, and manufactured equipment; contractors' overhead and profit; and fees; but without provision for overtime, bonuses for labour, or premiums for material or equipment.

(b) *Physical deterioration* is defined as the loss in value resulting from wear and tear in operation and exposure to the elements.

(c) *Functional obsolescence* is defined as the loss in value caused by conditions within the asset such as changes in design, materials, or process that result in inadequacy, overcapacity, excess construction, lack of utility, or excess operating costs.

(d) *Economic/external obsolescence* is defined as an incurable loss in value caused by unfavourable conditions external to the asset such as the local economy, economics of the industry, availability of financing, encroachment of objectionable enterprises, loss of material and labour sources, lack of efficient transportation, shifting of business centres, passage of new legislation, and changes in ordinances.

(e) The cost approach generally provides a meaningful indication of the value of special systems and special machinery and equipment.

The Sales Comparison Approach

4.5 In the sales comparison approach, value is estimated for the assets appraised through analysis of recent sales of comparable items of machinery and equipment. It is employed in the valuation of machinery and equipment and similar items for which there is a known used market. Under the premise of continued use, consideration is given to the cost to acquire similar items in the used-equipment market; an allowance then is made to reflect the costs for freight and installation.

4.6 When market transactions of comparable assets are not available, when data cannot be extrapolated from larger transactions, or when transactions are nonexistent, the cost approach is the preferred valuation procedure.

The Income Capitalization Approach

4.7 In the income capitalization approach, value is developed on the basis of capitalization of the net earnings that would be generated if a specific stream of income can be attributed to an asset or a group of assets.

4.8 In any appraisal study, all three approaches to value must be considered, as one or more may be applicable to the subject property. In some situations, elements of two approaches may be combined to reach a value conclusion.

4.9 Due to the nature of this valuation, contemplation of the continued use premise, and the custom nature of the installed Bezeq network, the cost approach was deemed to be the most appropriate valuation approach.

4.10 The income capitalization approach was deemed inappropriate for use in this appraisal since individual income streams necessary to develop such analyses are not typically assigned to specific equipment units within the business's financial reporting data.

5. Fixed Asset Valuation

5.1 The subject Assets form part of Bezeq's switching centres, throughout Israel, and are, as such part, of the broader telecommunications sector and the Israeli telecommunications market.

5.2 The subject Assets form only a part of the Bezeq asset base and have been valued on the basis that they would continue to operate within the overall Bezeq network, unless otherwise identified.

Cost of Reproduction

5.3 The initial step in valuing the Assets was to establish a reproduction cost for the telephone equipment under appraisal. As part of this process, original costs were examined for completeness and an indication of local cost trends.

5.4 First, we reviewed an internal, non published, replacement cost study, performed by Bezeq, which had been prepared in support of this effort. This study included consideration of data developed from a previous Bezeq study, performed in 2005, which examined 2005 switch replacement costs.

5.5 Freight, installation, and all other soft costs were included in the replacement cost, based on the company's historical data and/or recent expenditures.

5.6 We established, through discussions with Bezeq management, that the replacement cost study was undertaken, based upon replacement of the network switches with comparable technology, and that use of any alternate technology was neither commercially, or technically feasible, as at the date of appraisal.

5.7 In terms of costs for the Bezeq equipment, the costs were in local currency, FOB, Israel.

5.8 In order to further establish the reasonableness of the concluded replacement cost, an appropriate index was selected and applied against the original cost data in order to establish a new reproduction cost of the Assets being valued. The index utilized was the AUS Telephone Plant Index for digital switches, published by AUS Consultants, a recognized telecom industry source.

5.9 Based on this effort and our experience with other telecom valuations, we determined the internally developed replacement costs to be a reasonable representation of the reproduction costs of the telephone equipment under appraisal.

Equipment Lives

5.10 To value the Assets, we established the ages of the equipment and their corresponding normal useful lives.

5.11 Our estimates for the equipment ages and useful lives were based on client records, for the equipment ages, and our in-house research to establish normal useful lives. This research included reviewing current industry publications, as well as published telecom equipment normal life data from both the private and public sector. We also reviewed previous valuation work we performed, as a check on the information we utilized.

5.12 A variety of sources were reviewed regarding the normal useful lives of the various categories of assets. These sources were from both the private and public segment, and included: the United States Federal Communications Commission, Verizon Cellular, Marshal Valuation Services, Technology Futures, Inc., the United States Internal Revenue Service, and the Florida Department of Revenue. This information has been published and readily available online to the public.

Physical Depreciation

5.13 The relationship between an asset's age and its normal life can be used to measure physical deterioration. Although this appears to be straight-line depreciation, it is not to be confused with accounting depreciation.

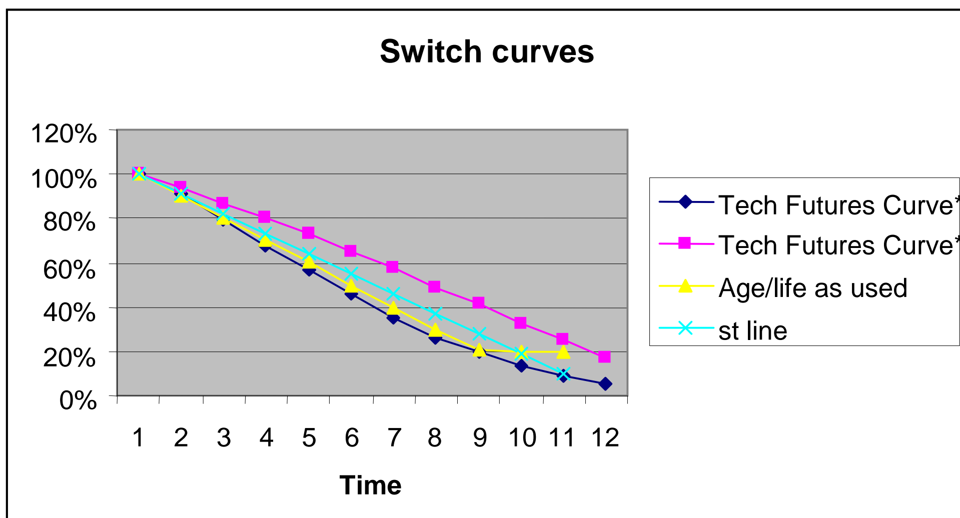
5.14 We chose an age/life depreciation approach as being the best representation of the diminution of the value of the appraised assets due to the nature of the specific assets, which do not have a robust secondary market, where market values can be readily identified and recorded.

5.15 Whilst other depreciation “curves”, derived from some market and mortality data for similar assets in other countries, do exist, they are not specific to either the assets appraised, or the local market, and hence were reviewed in order to establish the reasonableness of the age/life methodology.

5.16 We reviewed published sources of data concerning the lifecycle and depreciation of telecommunications equipment. Significant amongst the sources reviewed was a report published by Technology Futures Inc., a US based company which specialises in Technology Market Forecasting and the Telecommunications Technology Forecasting Group.

5.17 The TFI study determines composite survivor rates for a range of telecommunications assets, based upon a combination of asset mortality/survival rates, competitive influences and technology survival/substitution. The two curves featured evidence forecast depreciation, both with* and without** the impact of competition.

5.18 Whilst the forecast depreciation rates established under these studies are based upon US data, and are not specific to the exact equipment appraised, they provide tangible, underlying, support for the age/life depreciation methodology adopted in this appraisal, as shown in the following chart:



5.19 We reviewed the sensitivity of the valuation to the choice of depreciation method and confirmed that the use of the TFI curve, including the impact of market competition, instead of the age/life methodology applied, would result in an immaterial change in value.

5.20 In this method of determining a group of assets overall physical deterioration, the appraiser uses valuation concepts of age/life, rather than accounting concepts. Age/Life relies upon the useful lives of groups of assets versus their actual ages, resulting in a "used up" calculation. Useful life is defined in IAS 16 as "…the period in which an asset is expected to be available for use by an entity…".

5.21 The first step in determining the physical deterioration of a group of assets is to establish their ages. We accomplished it by reviewing client's records and/or discussions with client personnel.

5.22 Once the assets ages have been established, the ratio of an asset age to its life can be used to measure physical deterioration. This is determined by the following formula: (Effective Age/Physical Life = Percent of Physical Deterioration), where effective age is defined as the apparent age of an asset in comparison with a new like kind asset.

5.23 Given the type and nature of the equipment and its age, there were no functional issues of any note.

5.24 For this valuation, therefore, given the nature and types of assets involved, it was assumed that effective age equals actual age. Thus, in an instance where an asset has an effective age of four years and a normal physical life of ten years, its physical deterioration will be forty percent. This results in a sixty percent good factor for the asset, which is multiplied by the assets reproduction costs. This results in an asset's Fair Value.

5.25 This diminution in value will continue until the asset reaches its residual value. An asset's residual, or floor, value is an estimate of its value as it approaches the end of its useful life, however is maintained in regular operation with no immediate plan for its removal. This concept reflects the accepted valuation principle that as long an asset is used as part of an enterprise it has a value to that enterprise.

5.26 This residual, or floor value reflects the estimated costs of replacing the asset, with one of comparable vintage and condition, and includes consideration for freight and installation. When valuing assets regularly traded on the secondary market, this value is relatively easy to both discern, and document.

5.27 When valuing assets such as telephone switches and related equipment, which do not have the measurable market that some other asset groups possess, an estimate is necessary. This estimate of value is based on a percentage of the asset's reproduction cost.

5.28 Common valuation practice clearly indicates that this percentage ranges anywhere from five to twenty-five percent of an asset's reproduction cost, depending on several factors, including the anticipated future use of this asset by its owner, and/or how much longer will this asset be a part of the business enterprise.

5.29 Floor values of Twenty percent are often used for significant or special type assets. The most common source for twenty percent floors is Marshall & Swift's Marshall Valuation Services manual, published annually.

5.30 As the owner's intent is not to remove the assets from service, in the near future, no adjustment was made to reflect the any diminished value as a result of the assets having a shortened life. In applying the age/life approach, therefore, we applied a 20% floor to the values, reflecting the fact, that under the premise of continued use, the assets retain some value to the ongoing operation of the business.

5.24 There was no substantial evidence of sales of used equipment, in the market, within Israel, and at around the date of appraisal, Bezeq had neither bought nor sold used switches, at or around the time of the appraisal.

5.25 As part of our engagement we reviewed the sensitivity of the valuation to the floor value assumption and confirmed that an elimination of the floor value would result in an immaterial change in value.

5.26 The sensitivity of the valuation to changes in the floor value assumption are as follows:

0%	**548,290,000**

5%	**563,050,000**
10%	**577,790,000**
15%	**720,350,000**
20%	**862,860,000***

* Reported Value

5.27 As part of our effort, we visited twenty-five Bezeq equipment sites. The assets at these sites accounted for approximately fifty percent of the overall Fair Value of the assets. The purpose of this visit was to: 1) confirm the existence of major assets, 2) inspect the facility for overall condition, and 3) establish the utility of the assets. Our inspection revealed all major assets to be accounted for with the appearance of all being in good condition and fully utilized.

5.28 The remaining locations were not visited and, therefore, we cannot accept responsibility for the accuracy of the records upon which our studies are based. We have assumed they are a reasonable representation of the facts.

6. Conclusion

6.1 Based upon the investigation described herein, it is our opinion that the Fair Value of the subject Assets, as of 1 January 2005, is reasonably represented in the amount of: **862,860,000** NIS (Eight hundred sixty two million, eight hundred sixty thousand NEW ISRAELI SHECKELS).

6.2 This report is prepared in accordance with, and subject to, our General Service Conditions and Assumptions and Limiting Conditions which form part of this letter.

6.3 Unless the facts and circumstance suggested otherwise, our opinion of Fair Value was prepared on the basis of continued use. Accordingly, we have assumed that the Assets will continue to be used in the ongoing business of Bezeq, and this opinion of value does not represent the amount that might be realised from the piecemeal disposition of the assets in the open market.

6.4 This opinion of Fair Value has been prepared under the assumption that the earnings of the operation in which the Assets are utilised will be adequate to justify ownership of the Assets appraised.

6.5 We have not investigated the title to, or any liabilities against, the property appraised and no responsibility is assumed for these matters.

6.6 We hereby certify that we have neither a present nor a prospective interest in the Company, the Assets appraised or the value reported.

Appendix A – Information Received

"Bezeq switches1 6.02.07 AAA" Excel file, provided to us by Bezeq

Bezeq 2005 Internal Replacement Cost Study

Appendix B – General Service Conditions

Agreement – The Contract governing this engagement including these General Service Conditions represents the entire agreement between American Appraisal and the Client. It supersedes any prior oral or written agreement and may not be altered except by the mutual written agreement of all parties thereto.

Assignment – Neither party may assign, transfer, or delegate any of the rights or obligations hereunder without the prior written consent of the other party; unless such assignment is based upon the lawful transfer to a successor in interest of all or substantially all of the party's assets or business interests.

Client of Record – Only the signed Client(s) of Record may rely on the results of American Appraisal's work. No third party shall have the reliance or contractual rights of American Appraisal's Client(s) of Record without American Appraisal's prior written consent. No party should rely on the results of American Appraisal's work as a substitute for its own due diligence.

Communication – Electronic media including voice-mail, e-mail, and faxes are acceptable vehicles to communicate all materials unless such communication forms are expressly prohibited in the Contract. Client shall not assume or deem the Client Service Team assigned by American Appraisal to any work contemplated by the Contract to have knowledge of information provided to others not part of that team.

Contingent Fees – American Appraisal's compensation is not contingent in any way upon its opinions or conclusions or upon any subsequent event directly related to those opinions or conclusions. Client shall pay American Appraisal's invoices in accordance with their stated terms.

Confidentiality – American Appraisal will maintain the confidentiality of the Client's confidential information with the same degree of care that American Appraisal uses to keep its own materials confidential, and in any event, the degree of care shall be reasonable, and shall not disclose it to anyone or use it for any purpose whatsoever other than Client's engagement, provided that in the event that American Appraisal is legally compelled to disclose such information, American Appraisal shall provide Client with prompt written notice so that Client may seek a protective remedy, if available. Any such access shall continue to be subject to the same confidence by both American Appraisal and the applicable organization. Information shall not be treated as confidential if: (i) it is now or later available to the public, (ii) at the time of disclosure to American Appraisal, the information was already in its possession, or (iii) the information was obtained from a third party under no obligation of confidentiality to Client.

American Appraisal shall have the right of review, in advance of the publication of any document in which its report is either referenced or disclosed, in full or in part.

American Appraisal shall have the right to include Client's name in American Appraisal's client list.

Force Majeure – Neither the Client nor American Appraisal shall be liable for delays or for failures to perform according to the terms of the Contract due to circumstances that are beyond their individual control.

Governing Law, Jurisdiction and Venue – This Contract shall be governed by Israeli Law within the jurisdiction of any court located in Israel, having subject matter jurisdiction.

Indemnification – Client shall indemnify American Appraisal for all reasonable attorneys' fees, that American Appraisal incurs as a result of becoming part of, or named in, an administrative or legal dispute in connection with this Engagement, except to the extent caused by American Appraisal's negligence or misconduct. Client shall have the right to approve or appoint American Appraisal's counsel in any such proceeding.

American Appraisal shall indemnify and hold harmless Client against and from any and all losses, claims, actions, damages, expenses or liability, including reasonable attorneys' fees, to which Client may become subject in connection with this engagement, and which are a direct result of American Appraisal's negligent or wilful act or omission

While on Client's premises, the personnel assigned by American Appraisal to any work contemplated by the Contract shall comply with all posted safety instructions or safety procedures requested by Client.

Independent Contractor – American Appraisal and Client shall be independent contractors with respect to each other. American Appraisal reserves the right to use subcontractors in executing the engagement. All subcontractors employed on this engagement will be subject to the same non-disclosure obligations as American Appraisal. American Appraisal is an equal opportunity employer. Subcontractors are defined herein as persons not employed by any companies within the American Appraisal or BDO networks. Subcontractors will not be used on this project without the prior written approval of Client.

Limits on the Use of the Work – American Appraisal's report may be used only for the specific use or uses stated in the Contract, and any other use is invalid.

Reliance on Information Provided by Client – American Appraisal is entitled to rely without independent verification on the accuracy and completeness of all of the information provided by Client or its advisors.

Retention – Unless stipulated to the contrary in the Contract or in a related written agreement, the Client shall have all proprietary rights in and to all files, documents, workpapers, and other results, developed during the course of the engagement ("Materials"). Unless requested otherwise by the Client, the materials will be retained by American Appraisal for a period of at least 7 years. During this retention period, Client shall have access to the Materials to assist it in completing the specific use or uses stated in the Contract, subject only to reasonable notification. Following the retention period, the Materials shall be forwarded to the Client or destroyed, as per the Client's request.

Scope of the Work – American Appraisal shall be obligated only for services specified in the Contract, and only for changes to the scope of those services that are set forth in any subsequent written agreement. As a result, the scope of the work does not include unrelated services or the responsibility to update any of the work after its completion. Further, American Appraisal reserves the right to decline to perform any additional services, if American Appraisal believes such services would create an actual or perceived conflict of interests, or would be illegal or in violation of applicable regulations or professional standards.

Standards of Performance – American Appraisal shall perform the engagement in accordance with applicable professional standards. However, professional services usually involve judgements made in an uncertain environment and based on an analysis of data that may be unverified or subject to change over time. Client and other parties to whom Client provides access to the results of American Appraisal's work shall evaluate the performance of American Appraisal based on the specifications of the Contract as well as on the applicable professional standards.

Testimony – American Appraisal's services do not include giving testimony or participating in or attending court or any other legal or regulatory hearing or inquiry. American Appraisal shall however participate or attend court or any legal or regulatory hearing or inquiry in connection with the services under the Contract and that Pelephone (or Bezeq) shall pay an amount as agreed by the parties in connection with such participation. Our fees for such services will be as follows: American Appraisal: US$300 per hour plus VAT and out of pocket expenses; BDO partner: US$120 per hour plus VAT; BDO senior manager: US$90 per hour plus VAT.

No Conflict of Interests – American Appraisal hereby represents that there is no conflict of interests between carrying out its obligations under this Contract and any other obligation or interest of American Appraisal. Should there be a possibility of such conflict of interests, American Appraisal shall notify immediately to the Client. The client shall be entitled, under these circumstances, to terminate immediately the Contract and/or any other measure in order to protect its rights.

Appendix C – Assumptions and Limiting Conditions

This service was performed with the following general assumptions and limiting conditions:

1. To the best of our knowledge, all data, including historical financial data, if any, relied upon in reaching opinions and conclusions or set forth in this report are true and accurate. Although gathered from sources that we believe are reliable, no guarantee is made nor liability assumed for the truth or accuracy of any data, opinions, or estimates furnished by others that have been used in this analysis.

2. No responsibility is assumed for matters legal in nature. No investigation has been made of the title to or any liabilities against the property appraised. We have assumed that the owner's claim is valid, the property rights are good and marketable, and there are no encumbrances that cannot be cleared through normal processes, unless otherwise stated in the report.

3. The value or values presented in this report are based upon the premises outlined herein.

4. The date of value to which the conclusions and opinions expressed apply is set forth in the report. The value opinion presented therein is based on the status of the economy and on the purchasing power of the currency stated in the report as of the date of value (1 January 2005).

5. This report has been made only for the use or uses stated, and it is neither intended nor valid for any other use.

6. Possession of this report or any copy thereof does not carry with it the right of publication. No portion of this report (especially any conclusion, the identity of any individuals signing or associated with this report or the firms with which they are connected, or any reference to the professional associations or organizations with which they are affiliated or the designations awarded by those organizations) shall be disseminated to third parties through prospectus, advertising, public relations, news, or any other means of communication without the written consent and approval of American Appraisal.

7. Areas, dimensions, and descriptions of property, if any, used in this analysis have not been verified, unless stated to the contrary in the report. Any areas, dimensions, and descriptions of property included in the report are provided for identification purposes only, and no one should use this information in a conveyance or other legal document. Plats, if any, presented in the report are intended only as aids in visualizing the property and its environment. Although the material was prepared using the best available data, it should not be considered as a survey or scaled for size.

8. Unless stated to the contrary in the report, no environmental impact study has been ordered or made. Full compliance with all applicable laws and governmental regulations is assumed unless otherwise stated, defined, and considered in the report. We have also assumed responsible ownership and that all required licenses, consents, or other legislative or administrative authority from any applicable government or private entity organization either have been or can be obtained or renewed for any use that is relevant to this analysis.

9. The value estimate contained within the report specifically excludes the impact of substances such as asbestos, urea-formaldehyde foam insulation, other chemicals, toxic wastes, or other potentially hazardous materials or of structural damage or environmental contamination resulting from earthquakes or other causes, unless stated to the contrary in the report. It is recommended that the reader of the report consult a qualified structural engineer and/or industrial hygienist for the evaluation of possible structural/environmental defects, the existence of which could have a material impact on value.

Appendix D – Schedule of Values

Switch num	Site num	Switch Name	Operation start date	Total costs - adjusted		Fair Value 1.1.05 (NIS Thousands) (20% Residual)	Comments
				Acquisition amount (NIS thousands)	Net Book Value (NIS thousands)		
95291	10858	Zomet hasharon1	30/6/1996	79,300	21,314	11,080	
99421	10858	Zomet Asharon2	30/6/1996	35,784	11,273	5,000	
92250	1002	Koresh Jer	30/6/1997	56,981	14,128	8,810	
92263	1003	Merhavia	30/6/1998	25,288	9,788	5,770	
92436	1004	Qiryat yovel1	30/6/1995	89,944	19,438	10,700	
92437	1004	Qiryat yovel2	30/6/1996	40,670	13,937	5,680	
90251	1005	Givat Shaul	30/6/1996	21,329	7,292	2,980	
92380	1006	Romema	30/6/1996	52,376	9,592	7,320	
90276	1007	Gilo	30/6/1996	38,684	11,258	5,410	
90277	1007	Gilo **STP**	30/6/2006	-	-	-	
92731	1008	Talpiot	30/6/1996	38,145	9,172	5,330	
92790	1009	Golomb	30/6/1996	21,296	5,924	2,970	
92274	1010	Hordus	30/6/1996	31,892	4,862	4,450	
92820	1011	Ramat eshcol	30/6/1996	63,563	19,141	8,880	
92890	1012	Neve yacov	30/6/1995	35,123	9,401	4,180	
90286	1013	Ramot	30/6/1998	48,425	14,926	11,040	
93523	1014	Zafon	30/6/1996	44,512	11,392	6,220	
93525	1015	Dafna	30/6/1996	145,212	77,820	20,290	
93571	1017	Givhataiim	30/6/1996	53,515	11,855	7,480	
93365	1020	Yaood	30/6/1997	26,731	7,625	4,140	
93537	1021	Tahana Merkazit	30/6/1996	84,581	14,555	11,820	
93516	1022	Yad Eliaoo	30/6/1995	69,505	28,199	8,270	
93542	1023	Ramat Aviv	1/1/1997	51,999	15,240	8,120	
90346	1024	Yarkon1	1/1/1997	36,052	5,918	5,620	
93504	1024	Yarkon2	30/6/1996	11,048	4,540	1,550	
93506	1024	Yarkon **STP**	30/6/2005	2,283	2,280	-	**After Appraisal Date**
93677	1025	Dan	30/6/1996	76,245	18,869	10,650	
93548	1026	Ramat hashron	30/6/1997	28,236	7,661	4,370	
93566	1027	Mikve	30/6/1996	64,844	21,102	9,060	
93567	1027	Mikve **STP**	1/1/2000	531	642	210	
93510	1028	MaaravTA1	30/6/1996	50,945	12,399	7,120	
93511	1028	MaaravTA2 Tan	30/6/2000	6,732	4,020	2,570	
93672	1029	Ramat Gan	30/6/1996	32,127	8,594	4,490	
93574	1030	Ramat Izhak	1/1/1997	35,639	11,693	5,560	
93579	1031	Bene brak1	30/6/1996	108,903	27,439	15,210	
93582	1031	Bene brak2	30/6/2000	7,701	4,689	2,930	
93556	1032	Azur	30/6/1995	57,137	11,006	6,790	
90381	1033	Darom	30/6/1996	52,782	14,451	7,370	
90382	1033	Darom **STP**	30/6/2001	1,362	1,293	700	
93503	1034	Holon	30/6/1996	34,692	13,297	4,850	
93550	1035	Bat yam1	30/6/1998	43,717	13,068	9,970	
93658	1035	Bat yam1b		742	891	170	
90421	1036	Mizrhch haifa	30/6/1997	29,977	8,968	4,640	
94260	1037	Ahooza2	30/6/1996	14,162	3,817	1,980	
94340	1037	Ahooza1	30/6/1997	11,326	5,456	1,750	
94330	1038	Carmel tzarfati	30/6/1996	62,922	16,141	8,790	
94500	1040	Marav haifa	30/6/1996	15,695	6,974	2,190	
94501	1040	Marav haifa2	30/6/1997	30,877	10,298	4,780	
90461	1042	Borg	30/6/1996	88,644	18,991	12,380	
94731	1043	Motzkin	30/5/1995	22,426	5,080	2,640	
90475	1045	Qiryat yam	30/6/1996	31,163	9,169	4,350	
92101	1048	Bar cohova	30/6/1996	92,635	42,387	12,940	
92102	1048	Bar cohova **STP**		-	-	-	
92539	1062	Maoz zion	30/6/1996	34,016	9,773	4,750	
92912	1064	Bet shemesh	30/6/1997	38,205	15,129	5,910	
93685	1073	KorshA	30/6/1995	50,679	12,083	6,030	
93102	1085	Koresh G	30/6/2005	355	454	-	**After Appraisal Date**
93561	1085	Koresh G DMS100	30/6/1995	54,623	15,123	6,500	
93562	1085	Koresh G **STP**	30/6/1996	3,193	2,112	440	
93531	1087	Or yehuda	30/6/1996	35,443	8,123	4,960	
93541	1088	Tochnit L	30/6/1996	49,981	13,009	6,980	
93551	1089	Bat yam ta'	30/6/1996	113,244	30,792	15,820	
93552	1089	Bat yam ta' **STP**		-	-	-	
93659	1089	Bat yam ta'2		878	479	120	
93721	1090	Rama	30/6/1996	110,833	19,951	15,480	
93934	1091	Petach tikva1	1/1/1997	33,393	13,367	5,210	
93921	1092	Petach tikva2	1/1/1997	83,563	31,857	13,040	
93922	1092	Petach tikva2 tandem	30/6/1999	418	250	120	
93932	1093	Oron	30/6/1997	88,692	29,458	13,720	
93933	1093	Oron tandem		1,965	185	310	
93950	1094	Rashlaz2	30/6/1998	5,175	3,759	1,180	
93963	1094	Rashlaz **STP**		-	-	-	
93964	1094	Rashlaz1	30/6/1996	80,264	23,118	11,220	
93938	1097	Rosh hain	30/6/1996	50,125	13,789	7,010	
93961	1098	Ramat elyahoo	30/6/1996	85,379	32,529	11,930	
93973	1102	Ben-Guriun Airport	30/6/1996	45,535	14,701	6,360	
94350	1106	Reches **STP**	30/6/1998	868	322	200	

Switch num	Site num	Switch Name	Operation start date	Total costs - adjusted Acquisition amount (NIS thousands)	Net Book Value (NIS thousands)	Fair Value 1.1.05 (NIS Thousands) (20% Residual)	Comments
94360	1106	Reches2	30/6/1997	10,442	3,524	1,610	
94370	1106	Reches1	30/6/1996	55,687	15,371	7,780	
94411	1107	Mifraz2	30/6/1997	74,895	17,275	11,590	
94821	1114	Naharia2	30/6/1998	17,516	4,736	3,990	
94922	1116	Naharia1	30/6/1996	41,646	11,752	5,820	
94831	1117	Qiryat tivon	30/6/1997	18,530	4,420	2,870	
94950	1121	Kefar yasif	30/6/1995	14,903	3,820	1,770	
94001	1122	Shikmona **STP**	30/6/1998	1,636	640	250	
94002	1122	Shikmona	30/6/1998	10,559	2,994	2,410	
94867	1122	Shfaram	30/6/1996	8,765	4,370	1,220	
94972	1125	Maalot	30/6/1996	20,969	5,808	2,930	
94881	1126	Carmiel	30/1/1900	51,575	12,614	7,070	
94811	1127	Acco	30/6/1996	18,720	5,915	2,610	
94891	1128	Yokneam	30/6/1996	11,429	2,730	1,600	
97722	1131	Ashkelon migdal	30/6/1997	6,028	2,619	930	
95176	1134	Afridar	30/6/1996	26,454	7,796	3,690	
97880	1140	Qiryat gat1	30/6/1997	58,206	12,722	9,010	
97881	1140	Qiryat gat2	30/6/2002	8,366	7,162	4,520	
95231	1144	Kefar Saba	30/6/1996	140,058	41,228	19,570	
95297	1151	Herzelia1	30/6/1996	153,153	31,965	21,400	
95298	1151	Herzelia **STP**	30/6/2004	1,579	1,968	1,180	
99951	1151	Herzrlia2	1/1/1999	13,525	6,439	4,050	
95363	1157	Netania1	30/6/1996	179,146	51,680	25,020	
99832	1157	Netania2	30/6/1996	29,874	14,143	4,170	
95362	1158	Ezorim	30/6/1996	90,633	22,876	12,660	
90985	1167	Kfar yona	30/6/1997	40,667	8,810	6,290	
95561	1174	Ashdod1	1/1/1997	91,079	22,919	14,210	
95559	1175	Ashdod2	30/6/1996	105,686	33,682	14,770	
95581	1176	Qiryat malachi	30/6/1997	18,207	4,924	2,820	
95746	1182	Sanhedrin	30/6/1996	24,314	8,096	3,390	
95727	1184	Beer sheva1	30/6/1996	98,205	27,056	13,720	
95727	1184	Beer sheva1 **STP**	1/1/1997	-	-	-	
97290	1184	Beer sheva2	30/6/1996	4,510	2,760	630	
95743	1197	Neot midbar **STP**	30/6/1996	-	-	-	
95743	1197	Neot midbar	30/6/1997	56,159	14,780	8,690	
95755	1200	Dimona	30/6/1996	8,469	5,273	1,190	
97971	1213	Arad	1/1/1998	43,319	10,900	9,920	
97372	1217	Eilat1	30/6/1996	18,291	3,187	2,550	
95931	1218	Eilat2	30/6/1996	23,979	5,484	3,350	
96340	1221	Hadera1	30/6/2003	1,212	1,127	840	
96341	1221	Hadera2	1/1/1997	69,684	17,477	10,870	
96341	1221	Hadera2 **STP**	1/7/1997	-	-	-	
96342	1221	Hadera3	30/6/2004	6,635	5,678	4,970	
96377	1225	Pardes Hana	30/6/1996	18,078	4,801	2,520	
96390	1228	Zicron Yacov	30/6/1998	19,865	6,125	4,530	
96545	1234	Migdal Aemek	30/6/1996	15,663	2,899	2,180	
96560	1235	Nzrat1	30/6/1995	52,801	8,331	6,280	
96561	1235	Nzrat2	30/6/1996	38,171	10,631	5,330	
96773	1246	Tveria elit	30/6/1995	26,474	6,291	3,150	
96781	1247	Eilaboon	30/6/1998	13,439	3,233	3,060	
96970	1254	Zefat	30/6/1998	19,136	4,041	4,360	
96940	1256	Qirit Shemona	30/6/1997	24,522	5,343	3,790	
98221	1263	Ayalon1	30/6/1996	180,949	51,536	25,280	
98223	1263	Ayalon2	30/1/2000	4,549	5,939	1,730	
98436	1266	Rehovot2	30/6/1996	37,245	10,654	5,200	
98401	1267	Ness ziona	30/7/1997	16,237	6,029	2,470	
98430	1269	Yavne	30/6/1996	30,736	8,245	4,290	
96526	1446	Aafoola	1/1/1997	90,325	15,929	14,090	
96526	1446	Aafoola **STP**	30/6/1997	-	-	-	
96723	1451	Tveria Ta	30/6/1997	9,678	3,833	1,490	
93528	1912	Nodia	1/1/1997	45,444	6,063	7,090	
98209	1961	Modihin	1/1/2004	12,802	10,820	9,760	
98410	2748	Oshiot	30/6/1996	72,115	27,211	10,080	
90335	2945	Qirhon	30/6/1996	59,427	16,988	8,300	
94210	2969	Nesher	30/6/1995	22,580	5,857	2,690	
98270	3169	Reut	30/6/1997	44,549	12,752	6,890	
99791	3723	Raanana1	1/1/1997	33,826	8,363	5,280	
99792	3723	Raanana2 Tandem	30/6/1997	21,221	9,497	3,280	
99793	3723	Raanana **STP**	30/6/2004	1,353	1,454	1,010	
94844	8128	Qiryat ata	1/7/1997	12,729	4,026	1,940	
				5,771,849	**1,675,235**	**862,860**	

Appendix E – Resumes of Senior Team Members

Ian W. Gough
Managing Director, Industrial Valuation
American Appraisal (UK) Limited

Position

Ian Gough is the Managing Director of American Appraisal's Industrial valuation practice in the UK. In addition to operating in his management role, Ian Gough acts as a Managing Consultant, managing multidisciplined and multinational valuation and consulting engagements.

Experience

Business

For several years prior to joining American Appraisal, Ian Gough was employed as a consultant by one of the world's leading firms of chartered accountants.

Additionally Mr Gough has experience in the management construction projects, gained with a regional public body and a major utility.

Valuation

Since joining American Appraisal, Mr Gough has been involved in the valuation of a diverse range of businesses and asset types, encompassing industrial and commercial property, machinery and equipment as well as intangible assets and the total business enterprise.

Mr Gough's consulting expertise encompasses a wide variety of industry sectors including: chemical, petrochemical, transportation, packaging, paper, engineering, food and drink, telecommunications, hi tech manufacturing, leisure and utilities.

In the 17 years that he has been with the firm, Ian Gough has undertaken valuations for a wide variety of purposes including: mergers & acquisitions, allocation of purchase price, financial reporting, taxation, purchase and sale, financing, and privatisation purposes.

Mr Gough has undertaken and managed valuation and consulting engagements on 4 continents and has provided appraisal services in more than 25 countries.

Education

BSc (Hons) Civil Engineering

Professional Affiliations

FRICS Fellow of the Royal Institution of Chartered Surveyors
MACostE Member of the Association of Cost Engineers

Graduate of the Institute of Civil Engineers
Member of the European American Tax Institute
Member of the Institute of Directors

Publications/Speeches	"Valuation – Meeting the needs of the global investor" Article in Property Forecast
	"Managing the Appraisal Process/The Role of an Appraisal Firm" Lectures to MBA students, University of Exeter
	"Appraisal in the Emerging Markets of E. Europe" articles in American Chamber of Commerce Newsletters
	"Incorporating Risk into the Valuation of High Tech Assets" Conference Presentation, London

Specific Telecommunications Experience

Atlas Online	Pre IPO valuation of a Turkish Internet Service Provider.
Belgacom	Valuations of Various equipment assets (fixed and mobile) for the Belgian state telecommunications operator for sale/leaseback.
British Telecom	Valuation of various network assets for structured financing. *(Project Review Authority, UK)*
Eircom	Valuations of Irish telecom network equipment for leasing Valuation of the business units of the Irish landline operation for purchase price allocation. *(Project Director)*
France Telecom	Pre IPO study of "Orange" Mobile Network in UK for France Telecom following its acquisition of the business. *(Project Director)*
GPT	Valuation of network assets for financial reporting in advance of privatization. *(Project Director)*
GTS	Numerous valuations of networks and operations around Europe for restructuring. *(Project Director, European Assets)*
Lattice Telecoms	Valuation of the broadband telecoms assets of a UK utility provider for restructuring. *(Project Director)*
MCI Worldcom	Valuation of Pan European and transatlantic networks for internal restructuring *(Project Director)*

	Valuation of worldwide assets for the planned emergence of the company from bankruptcy. *(Project Review Authority, European Fixed Assets)*
OTE	Valuation of Tangible assets in connection with the privatisation of Greek Telephone Network.
O2	Valuation of various network assets for tax planning. *(Project Director)*

Daniel D Zoller Jr, ASA
Managing Director and Vice President,
Industrial Valuation Group

Position

Daniel D Zoller Jr is the managing director of the Atlanta Industrial Valuation Group of American Appraisal Associates, Inc.

Experience

Valuation

Mr Zoller has provided appraisal services to determine fair market value for allocation of purchase price; liquidation and auction values for financing; retrospective cost analysis for recapture studies; insurance values; residual and terminal leasing values; and review and valuation for ad valorem tax purposes.

Mr Zoller has completed valuation assignments in a variety of industries, including metalworking; mining; petrochemicals; electronics; high technology and telecommunications; food processing; general manufacturing; textiles; and diagnostic, rehabilitative, and general health care. He also has extensive asset-based appraisal experience through his work in the banking industry and has completed joint venture valuations for both domestic and international operations. Most recently, Mr Zoller has been involved in significant ad valorem tax valuations. In addition, he has completed major international valuation assignments in Brazil, Mexico, Jamaica, and Puerto Rico.

Court

Mr Zoller has qualified as an expert witness in bankruptcy and/or tax courts in Florida, Georgia, Louisiana, and North Carolina.

Business

Prior to rejoining American Appraisal in 2000, Mr Zoller had been with American Appraisal from 1988 through 1992. He has served in staff, senior, and managerial appraisal positions.

Mr Zoller has 30 years of experience in heavy construction projects and in industrial valuations. He was involved in major infrastructure projects in the Mideast, where he developed expertise in construction cost, budgeting, planning, and forecasting. Mr Zoller has experience in the sale, rental, and leasing of heavy construction and industrial equipment in domestic positions. He has also taught college-level courses in various subjects.

Education

Central Michigan University
Master of Science
Pennsylvania State University
Bachelor of Arts

Professional Affiliations	American Bankruptcy Institute, Member American Society of Appraisers, Accredited Senior Appraiser: Machinery and Technical Specialties/Machinery and Equipment Region 2 District Director Atlanta Chapter Distinguished Member Award, 2001 President, 2002-2004 Senior Vice President, 2001-2002 Vice President, 1998-1999 Institute for Professionals in Taxation, Member International Association of Assessing Officers, Associate Member
Valuation and Special Courses	Ad Valorem Valuation Appraisal of Inventory Business Enterprise Valuation Civil Construction and Architectural Component Valuation Techniques Cost Segregation Seminar Current Cost Development for Risk Management and Coinsurance Financial Valuation Theory Fixed Asset Accounting Fundamentals of Real Property Appraisal Income Approach to Value Intangible Asset Valuation Theory Personal Property Valuation/Assessment Uniform Standards of Professional Appraisal Practice
Speeches	"Valuation of Machinery and Equipment Under FAS 144" "Methods for the Valuation of Idle Equipment for Ad Valorem Tax Purposes" "Expert Witness Testimony: Different Approaches" "Amoco vs. Forsyth County, Georgia"

Cynthia N White, ASA
Consultant, Industrial Valuation Group

Position

Cynthia N White is a consultant for the Atlanta Industrial Valuation Group of American Appraisal Associates, Inc.

Experience

Valuation

Ms White values fixed assets, and has developed their cost of reproduction new, cost of reproduction new less depreciation, fair value and fair market value under the premise of continued use, orderly liquidation value, and auction value for purposes including insurance, purchase price allocation, financing, and financial reporting. She has served the metalworking, manufacturing, information technology, chemical, printing, textiles, and retail industries.

Business

Ms White joined American Appraisal in 1990. With a background as an appraisal administrator, she became an associate appraiser and was promoted to her current position in 2006.

Professional Affiliations

American Society of Appraisers, Accredited Senior Appraiser:
Machinery and Technical Specialties/Machinery and Equipment
Atlanta Chapter Secretary, 2004-Present

Valuation and Special Courses

Introduction to Machinery and Equipment
Machinery and Equipment Valuation Methodology
Machinery and Equipment Valuation - Advanced Topics and Case Studies
Machinery and Equipment Valuation - Advanced Topics and Report Writing
Uniform Standards of Professional Appraisal Practice
Machinery Identification Conference, October 2001
Valuation of Machinery and Equipment - Advanced Concepts
Finance and Accounting for Non-Financial Managers

Pini Schmeuli Nissan
Partner
BDO Consulting Group

Position

Pini Shmueli-Nissan is a Partner with BDO Ziv haft Consulting Group, in Tel-Aviv

Experience
Business

Mr. Shmueli-Nissan is highly experienced in economic and strategic consultant to various industries, specializing in the technology industry and the telecommunications and internet sectors. Mr. Shmueli-Nissan is responsible for numerous comparative research opinions and valuations in the field.

Mr. Shmueli-Nissan has been involved in several significant procedures in the telecommunication area, including, inter alia, Bezek's privatization and the competitive implementation in the communication market.

He has accompanied a large number of public and private issues, and consults many technology companies in merger and acquisition transaction.

Mr. Shmueli-Nissan has consulted a number of local telecommunication companies, such as Matav and Barak. Pini headed a number of telecommunications and internet research projects for the Israeli Ministry of Communications, Israeli banks and other Israeli institutions.

Mr. Shmueli-Nissan managed the research and consulting department of Foresight Investments & Technological Research for four years. Previous to that, Mr. Shmueli-Nissan headed the corporate finance division of Ernst & Young (Israel) for two years. In both positions, he had directed a large number of valuation projects for the biggest public companies in Israel such as Israel Chemicals and private companies such as Partner and Yes.

He has also established cost accounting system for the air fields authority and Israel Railway.

Education

Mr. Shmueli-Nissan holds an M.A. in Economics and business Administration from Tel Aviv University.

BA program, Faculty of Social Arts, Ben Guryon University, Economics and Accountancy

Nir Peles, CPA, MBA, MA$_{\textbf{(Law)}}$
Senior Manager
BDO Consulting Group

Position Nir Peles is a Senior Manager with BDO Ziv haft Consulting Group, in Tel-Aviv

Experience Mr Peles is a corporate finance senior manager, his department consists of seven consultants, all of them dealing mainly with corporate finance.

Mr Peles joined BDO in 2005 after having worked as a business advisor for 5 years at a leading economic consultants firm, where he specialized in evaluations, expert opinions, economic opinions, financial statements analysis and business analysis. Previous to that he worked 3 years as an interne and auditor in Israel's largest accounting firms.

Mr Peles has managed and performed hundreds of economic consulting projects in his field of expertise, including valuation of public companies needed for M&A, expert opinions, fairness opinions, purchase price allocation appraisal, Stock options valuation, Economic and accounting Due Diligence, Equity research – on going coverage of 25 Israeli technological public companies, for the needs of Institutional Investors, Financial statements analysis, business analysis and financial consultancy on various economic issues, Business valuations of private companies and relate topics.

Education MA program, Faculty of Law, Bar Ilan University.
MBA program, The Leon Recanati Graduate School of Business Administration, Tel Aviv University, Major in Corporate Finance.
BA program, Faculty of Social Arts, Hebrew University in Jerusalem, Economics and Accountancy

Published Articles Mr Peles's seminar in economics, research into the macro-economic effects of car thefts in Israel, written together with a colleague, was published by the Israeli Quarterly Revue of Taxes, July 1998.
Mr Peles's review of the Israeli capital markets and the different opportunities of private companies to have their Initial Public Offering in Tel Aviv Stock Exchange was published recently in "Globs".

American Appraisal (UK) Limited

Aldermary House
10-15 Queen Street
London EC4N 1TX

Tel: 020 7778 0800
Fax: 020 7248 1453

Web site:
www.american-appraisal.co.uk

INTERNATIONAL VALUATION CONSULTANTS

REAL ESTATE APPRAISAL

PLANT AND MACHINERY APPRAISAL

FINANCIAL APPRAISAL

INVESTMENT RECOVERY GROUP

REAL ESTATE ADVISORY GROUP

Our Ref: IWG/IU3430

26th March 2007

The Directors
Pelephone Communications Ltd
33, Yizhak Rabin Rd.
Givataim
Tel Aviv 61620
Israel

F.A.O. Shani Tomer

Gentlemen

Re: Valuation of Network Assets

Further to the appraisal agreement, which was signed on 17th January 2007, we, American Appraisal (UK) Limited and BDO Consulting ("American Appraisal") have now completed our investigation and appraisal of certain client designated assets, exhibited to us as being the property of Pelephone Communications Ltd ("Pelephone" or "The Company" or "Client") and submit our findings in this draft appraisal report.

The assets comprised a quantity of client-specified equipment of various types, used within Pelephone's mobile phone network, and located throughout Israel.

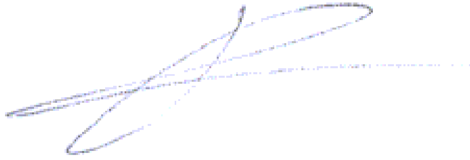
This Summary Appraisal report presents discussions of the data, reasoning, and analyses used in the appraisal process to develop American Appraisal's opinions of value.

Our report comprises this letter, an executive summary, a narrative section, together with appendices.

If you have any questions regarding the content of this report, please do not hesitate to contact me.

Yours faithfully

Ian W Gough
Managing Director, Industrial Valuation Group
For and On Behalf of American Appraisal (UK) Ltd
26th March 2007



Pini Shmeuli-Nisan
Partner, For and on behalf of
BDO Ziv Haft
Consulting & Management Ltd
26th March 2007

Pelephone Communications Ltd
Network Infrastructure Valuation
1 January 2005

[26 March 2007]

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Aldermary House
10-15 Queen Street
London EC4N 1TX

Tel: 020 7778 0800
Fax: 020 7248 1453

Web site:
www.american-appraisal.co.uk

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Managing Director, Industrial Valuation Group
For and On Behalf of American Appraisal (UK) Ltd
26th March 2007

The Definitive Standard Worldwide

BDO
ZIV HAFT
Consulting Group

Pini Shmeuli-Nisan
Partner, For and on behalf of

BDO Ziv Haft
Consulting & Management Ltd
26th March 2007

1. Executive Summary

Purpose of Assignment

1.1 The purpose of our independent investigation was to provide our opinion of the fair value of the subject assets.

1.2 We understand that the intended use of the appraisal is for financial reporting purposes in accordance with International Financial Reporting Standards ("IFRS"), and most specifically, for determining deemed cost in accordance with International Financial Reporting Standard 1 ("IFRS 1").

1.3 In undertaking this appraisal, and preparing this report, American Appraisal was cognisant of the requirements under IFRS for the determination of an opinion of value to be subsequently used as a deemed. Specifically American Appraisal was aware of the requirements of International Accounting Standard 16, "Property, Plant and Equipment" ("IAS 16"), and has undertaken this valuation in accordance with those requirements.

Basis and Premise of Value

1.4 The basis of valuation required to be adopted was "Fair Value", defined in IAS 16 as:

"*the amount for which an asset could be exchanged or a liability settled between knowledgeable willing parties in an arm's-length transaction.*"

Valuation Date

1.5 The valuation was undertaken as at 1 January 2005.

Information

1.6 In the course of performing our valuations we have reviewed certain information, provided to us by Pelephone's management teams, which included, inter alia, lists of assets, accounting records, equipment quantities, agreements, quotations and purchase orders. We have also had regard to publicly available industry information considered relevant to the activities undertaken by Pelephone.

Conclusion

1.7 Based upon the investigation described herein it is our opinion that, as of 1 January 2005, the Fair Value of the subject assets is reasonably represented in the amount of: **1,261,075,330** NIS (ONE BILLION TWO HUNDRED AND SIXTY-ONE MILLION SEVENTY FIVE THOUSAND THREE HUNDRED THIRTY NEW ISRAELI SHECKELS).

1.8 This report is prepared in accordance with, and subject to, our General Service Conditions and Assumptions and Limiting Conditions which form part of this letter.

1.9 Unless the facts and circumstance suggested otherwise, our opinion of Fair Value was prepared on the basis of continued use. Accordingly, we have assumed that the assets will continue to be used in the ongoing business of Pelephone, and this opinion of value does not represent the amount that might be realised from the piecemeal disposition of the assets in the open market.

1.10 Our opinion of Fair Value has been prepared under the assumption that the earnings of the operation in which the assets are utilised will be adequate to justify ownership of the assets appraised.

1.11 We have not investigated the title to, or any liabilities against, the property appraised and no responsibility is assumed for these matters.

1.12 We hereby certify that we have neither a present nor a prospective interest in the Company, the assets appraised or the value reported.

1.13 We confirm that our appointment was for a stand alone engagement, and does not form part of any ongoing relationship with Pelephone. We can confirm that we have not previously rendered valuation services to Pelephone.

1.14 Our fees for this engagement were based on the time required to provide our professional services and were in no way contingent upon the outcome of our conclusions.

1.15 Investigation and report by:

- Daniel D Zoller Jr, ASA

- Cynthia N White, ASA
- Ian W Gough, FRICS
- Pini Shmeuli Nisan
- Nir Peles

1.16 Professional assistance provided by:

- Kevin Phung
- Nick Goyal
- Erez Zahavi
- Hila Fisher

2. Introduction

Scope and Purpose

2.1 American Appraisal has been engaged by Pelephone to carry out an independent assessment of certain, client specified, network assets located within Israel.

2.2 The purpose of our independent investigation was to provide our opinion of the Fair Value of certain assets utilised in the Israeli telecommunications sector (the "Assets"), as specified by Pelephone.

2.3 We understand that the intended use of the appraisal is for financial reporting purposes in accordance with IFRS, and most specifically, for determining deemed cost in accordance with International Financial Reporting Standard 1 ("IFRS 1").

2.4 In undertaking this appraisal, and preparing this report, American Appraisal was cognisant of the requirements under IFRS for the determination of an opinion of value to be subsequently used as a deemed cost.

2.5 The basis of valuation required to be adopted was Fair Value, defined in IAS 16 as:

"*the amount for which an asset could be exchanged, or a liability settled between knowledgeable willing parties in an arm's-length transaction*".

2.6 Unless the facts and circumstance suggested otherwise, our opinion of Fair Value was prepared on the basis of continued use. We have assumed that the assets will continue to be used in the ongoing business of Pelephone, and accordingly, this opinion of value does not represent the amount that might be realised from the piecemeal disposition of the assets in the open market.

2.7 Our opinion of Fair Value has been prepared under the assumption that the earnings of the operation in which the Assets are utilised will be adequate to justify ownership of the Assets appraised.

2.8 The details of the scope of our engagement and our terms and conditions are included in our engagement letter, a copy of which is available under separate cover to this report.

2.9 When Fair Value is established on the premise of continued use, it is assumed that the buyer and the seller would be contemplating retention of the assets at their present location as part of the current operations. An estimate of Fair Value arrived at on the premise of continued use does not represent the amount that might be realized from piecemeal disposition of the assets in the marketplace, or from an alternative use of the assets. The premise of continued use is generally appropriate when:

- The assets are fulfilling an economic demand for the service they provide.
- The assets have a remaining useful life expectancy.
- Responsible ownership and competent management may be expected.
- Diversion of the assets to an alternative use would not be economically feasible or legally permitted.
- Continuation of the existing use by present or similar users is practical.
- Functional utility of the assets for their present use is given due consideration.
- Economic utility of the assets is given due consideration.

2.10 We did not investigate any financial data pertaining to the present or prospective earning capacity of the operation in which the designated Assets are used. It was assumed that prospective earnings would provide a reasonable return on the appraised value of the designated Assets, plus the value of any assets not included in the appraisal, and adequate net working capital. If prospective earnings are not adequate to justify ownership of the Assets at the appraised levels, then the concluded Fair Value as reported here, must be reduced accordingly.

Valuation Date

2.11 The valuation was undertaken as at 1 January 2005.

The Property Appraised

2.12 Our investigation dealt with client-designated Assets contained in the "Pelephone's Equipment List 10/01/07" Excel file, provided to us by Pelephone. This file contained details of assets to be appraised and comprised details of the asset categories and subcategories, quantities of assets and years of acquisition, together with the categories total cost, accumulated depreciation, and net book value.

Appraisal Services Provided

2.13 Our services included:

- Review of available existing data
- Project planning,
- Data gathering and interviews
- Sample asset inspections
- Correlation and valuation
- Valuation review
- Conclusion and reporting

Scope of Appraisal

2.14 During the course of our investigations we undertook a limited inspection of a sample of the Assets appraised. We did not, however, undertake a formal engineering survey of any of the subject Assets.

2.15 In the process of formulating our opinions of the costs, Asset lives and market values, we held discussions with the Pelephone management team regarding the history and nature of the various Assets, the operation, capacities, network life and condition.

2.16 Details of the Assets appraised follow later in the report.

Sources of Information

2.17 In the course of performing our valuations we have reviewed certain information, provided to us by Pelephone's management teams, which included, inter alia, lists of assets, accounting records, equipment quantities, agreements, quotations and purchase orders. We have also had regard to publicly available industry information considered relevant to the activities undertaken by Pelephone.

2.18 The principal information provided to us, and used in arriving at our valuation, is outlined in Appendix A.

Limitations

2.19 This document has been prepared solely for the directors of Pelephone for the purposes stated herein and should not be relied upon for any other purpose. We do understand and accept that a copy of this report may be provided to Pelephone's advisors and auditors.

2.20 We understand and accept that a copy of this report will be provided to Pelephone's advisors and auditors and that they will rely on it solely when expressing their opinion on the company's financial statements with regards to the presentation of property, plant and equipment, according to IFRS.

2.21 American Appraisal understands that the valuation report, might be published as part of Pelephone's, or Bezeq's period report and, potentially, if Pelephone, or Bezeq undergoes an IPO, or any other funding process in Israel or outside of Israel or shall publish a prospectus in Israel, or outside of Israel, the valuation might be published as part of Pelephone's, or Bezeq's prospectus.

2.22 We draw your attention to the fact that we are not permitted or regulated to provide investment advice. Whether or not a particular party chooses to invest in Pelephone (or a related party thereof) involves many additional considerations outside the scope of this report. Any such investment is a matter for individual parties and their financial advisors.

2.23 While our work has involved an analysis of information and records received, our engagement does not include any work in the nature of an audit. Accordingly, we assume no responsibility and make no representations with respect to the accuracy or completeness of any information provided by and on behalf of Pelephone.

2.24 Our engagement has been limited to the valuation of the identified Assets. We have not valued any other assets and liabilities pertaining to Pelephone.

2.25 We have provided a draft copy of this report to Pelephone's management who have confirmed, to the best of their knowledge and belief, that the factual information contained within this document is correct and that there are no material omissions. We reserve the right to alter our conclusions should any information that we were not

aware of at the time of preparing this report come to light, that has a material impact on the conclusions herein.

2.26 Our valuation has been prepared solely for the purpose defined and may not be used for any other purposes.

3. The Assets Appraised

3.1 Our assignment comprised an appraisal of the value of certain client specified Assets, identified as the property of Pelephone, and comprising equipment in the form of Pelephone's entire cellular network, but excluding Site Procurement, servers & applications which support its value added services and Motorola's Central Base Station Controller.

3.2 As instructed by Pelephone management we have included the categories, noted above, at their Net Book values, as at the date of appraisal

Nature of the Business

3.3 In order to appraise the Assets within the context of their continuing use, we first considered the operation in which they were employed the operating environment in Israel and the nature of the assets. The following, summary commentary is drawn from publicly available sources concerning the Pelephone operations.

3.4 Pelephone, the first cellular communications company in Israel, launched its services in 1986, and by doing so transformed the communications industry in the country. This change created a new inter-personal communication culture. Towards the end of 1998, Pelephone launched the advanced digital CDMA network, and since then has been committed to providing its customers with the best and most advanced services in the world. By the beginning of 2002, Pelephone started to put into place the CDMA 1X network, capable of transferring data communications at a speed of up to 144 Kbps.

3.5 2004 was a significant year from the developmental and technological point of view.

3.6 During this year, Pelephone launched its third generation network based on EVDO technology, enabling the transfer of data at a speed of up to 2.4 Mbps, and also launched phones and content suitable for third generation technology.

3.7 This technology will make possible a cellular experience that is rich in content. Cellphones will turn into television sets, and will be used to view clips from talk shows, sports, news, video clips, and songs with MP3 sound quality. So that it can offer a wide range of rich content to its customers, Pelephone has signed agreements with the leading content providers in Israel.

3.8 Business customers will be able to connect their cell phones to laptop computers and surf the internet by using a cellular PCMCIA modem card, and will also be able to download data at a speed of up to 2.4 Mbps.

4 Approach to Value

4.1 There are three generally accepted approaches to value, namely the cost, market and income approaches. The use of any one approach, or combination of approaches, is determined by the nature of the appraisal and the premise of value.

4.2 Before arriving at our opinions of value, we inspected a sample of assets at thirty-one Pelephone equipment sites. The assets at these sites accounted for over fifty percent of the overall Fair Value of the assets.

4.3 The theory of the three valuation approaches is outlined as follows:

Cost Approach

4.4 In the cost approach, value is established based on the cost of reproducing or replacing the asset, less depreciation from physical deterioration, and functional and economic/external obsolescence, if present and measurable.

(a) *Cost of reproduction new* is defined as the estimated amount required to reproduce a duplicate or replica of the asset at one time in like kind and materials in accordance with current market prices (as at January 1st 2005) for materials, labour, and manufactured equipment; contractors' overhead and profit; and fees; but without provision for overtime, bonuses for labour, or premiums for material or equipment.

(b) *Physical deterioration* is defined as the loss in value resulting from wear and tear in operation and exposure to the elements.

(c) *Functional obsolescence* is defined as the loss in value caused by conditions within the asset such as changes in design, materials, or process that result in inadequacy, overcapacity, excess construction, lack of utility, or excess operating costs.

(d) *Economic/external obsolescence* is defined as an incurable loss in value caused by unfavourable conditions external to the asset such as the local economy, economics of the industry, availability of financing, encroachment of objectionable enterprises, loss of material and labour sources, lack of efficient transportation, shifting of business centres, passage of new legislation, and changes in ordinances.

(e) The cost approach generally provides a meaningful indication of the value of special systems and special machinery and equipment.

The Sales Comparison Approach

4.5 In the sales comparison approach, value is estimated for the assets appraised through analysis of recent sales of comparable items of machinery and equipment. It is employed in the valuation of machinery and equipment and similar items for which there is a known used market. Under the premise of continued use, consideration is given to the cost to acquire similar items in the used-equipment market; an allowance then is made to reflect the costs for freight and installation.

4.6 When market transactions of comparable assets are not available, when data cannot be extrapolated from larger transactions, or when transactions are nonexistent, the cost approach is the preferred valuation procedure.

The Income Capitalization Approach

4.7 In the income capitalization approach, value is developed on the basis of capitalization of the net earnings that would be generated if a specific stream of income can be attributed to an asset or a group of assets.

4.8 In any appraisal study, all three approaches to value must be considered, as one or more may be applicable to the subject property. In some situations, elements of two approaches may be combined to reach a value conclusion.

4.9 Due to the nature of this valuation, contemplation of the continued use premise, and the custom nature of the installed Pelephone network, the cost approach was deemed to be the most appropriate valuation approach.

4.10 To a far lesser extent, the sales comparison approach was used in the valuation of the equipment that no longer was supported by the network and was in the process of being replaced.

4.11 The income capitalization approach was deemed inappropriate for use in this appraisal since individual income streams necessary to develop such analyses are not typically assigned to specific equipment units within the business's financial reporting data.

5. Fixed Asset Valuation

5.1 The subject Assets form part of Pelephone's digital cellular communications network, throughout Israel, and are, as such part, of the broader cellular communications sector and the Israeli telecommunications market.

5.2 The subject Assets form only a part of the Pelephone asset base and have been valued on the basis that they would continue to operate within the overall Pelephone network, unless otherwise identified.

Cost of Reproduction

5.3 The initial step in valuing the Assets was to establish a reproduction cost for the telephone equipment under appraisal. As part of this process, original costs were examined for completeness and an indication of local cost trends.

5.4 First, we reviewed cost data, maintained by Pelephone regarding telecom equipment reproduction costs as of January 1, 2005. We also performed a comprehensive review of highly confidential, vendor written, telecom cost quotes, as of 1 January 2005, which were maintained by Pelephone. We then contacted brokers and equipment dealers and/or vendors, and researched telecom equipment reproduction costs, as of the appraisal date.

5.5 Freight, installation, and all other soft costs were calculated based on the company's historical data and/or recent expenditures and were estimated accordingly.

5.6 In terms of costs for the Pelepone equipment, the costs were in local currency, FOB, Israel.

5.7 Based on this effort and our experience with other telecom valuations, we determined these costs to be a reasonable representation of the reproduction costs of the telephone equipment under appraisal.

Equipment Lives

5.8 To value the Assets, we established the ages of the equipment and their corresponding normal useful lives.

5.9 Our estimates for the equipment ages and useful lives were based on client records, for the equipment ages, and our in-house research to establish normal useful lives. This research included reviewing current industry publications, as well as published telecom equipment normal life data from both the private and public sector. We also reviewed previous valuation work we performed, as a check on the information we utilized.

5.10 A variety of sources were reviewed regarding the normal useful lives of the various categories of assets. These sources were from both the private and public segment, and included: the United States Federal Communications Commission, Verizon Cellular, Marshal Valuation Services, Technology Futures, Inc., the United States Internal Revenue Service, and the Florida Department of Revenue. This information has been published and readily available online to the public.

Physical Depreciation

5.11 The relationship between an asset's age and its normal life can be used to measure physical deterioration. Although this appears to be straight-line depreciation, it is not to be confused with accounting depreciation.

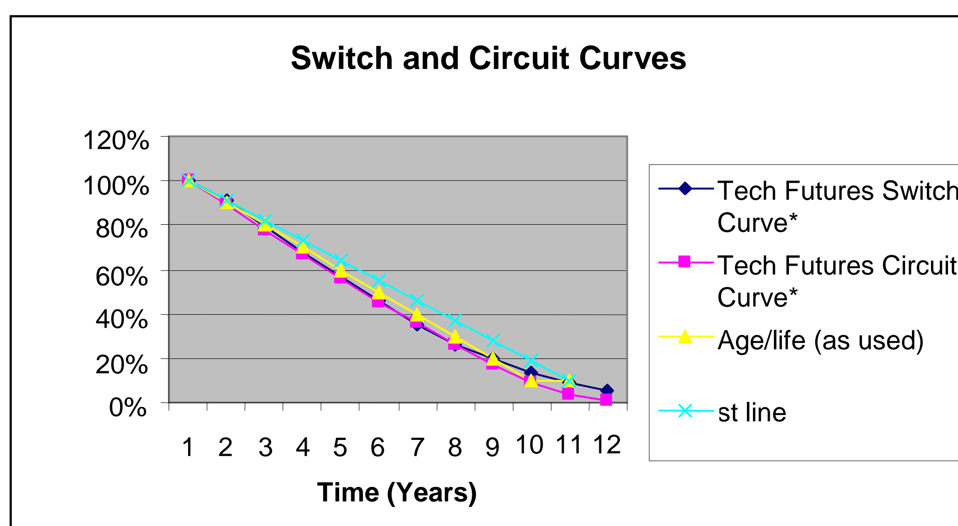
5.12 We chose an age/life depreciation approach as being the best representation of the diminution of the value of the appraised assets due to the nature of the specific assets, which do not have a robust secondary market, where market values can be readily identified and recorded.

5.13 Whilst other depreciation "curves", derived from some market and mortality data for similar assets in other countries, they are not specific to either the assets appraised, or the local market, and hence were reviewed in order to establish the reasonableness of the age/life methodology.

5.14 We reviewed published sources of data concerning the lifecycle and depreciation of telecommunications equipment. Significant amongst the sources reviewed was a report published by Technology Futures Inc., a US based company which specialises in Technology Market Forecasting and the Telecommunications Technology Forecasting Group.

5.15 The TFI study determines composite survivor rates for a range of telecommunications assets, based upon a combination of asset mortality/survival rates, competitive influences and technology survival/substitution.

5.16 Whilst the forecast depreciation rates established under these studies are based upon US data, and are not specific to the exact equipment appraised, they provide tangible, underlying, support for the age/life depreciation methodology adopted in this appraisal, as shown in the following chart:



5.17 In this method of determining a group of assets overall physical deterioration, the appraiser uses valuation concepts of age/life, rather than accounting concepts. Age/Life relies upon the useful lives of groups of assets versus their actual ages, resulting in a "used up" calculation. Useful life is defined in IAS 16 as "…the period in which an asset is expected to be available for use by an entity…".

5.18 We reviewed the sensitivity of the valuation to the choice of depreciation method and confirmed that the use of either curve noted above, instead of the age/life methodology applied, would result in an immaterial change in value.

5.19 The first step in determining the physical deterioration of a group of assets is to establish their ages. We accomplished it by reviewing client's records and/or discussions with client personnel.

5.20 Once the assets ages have been established, the ratio of an asset age to its life can be used to measure physical deterioration. This is determined by the following formula: (Effective Age/Physical Life = Percent of Physical Deterioration), where effective age is defined as the apparent age of an asset in comparison with a new like kind asset.

5.21 Given the type and nature of the equipment and its age, there were no functional issues of any note.

5.22 For this valuation, therefore, given the nature and types of assets involved, it was assumed that effective age equals actual age. Thus, in an instance where an asset has an effective age of four years and a normal physical life of ten years, its physical deterioration will be forty percent. This results in a sixty percent good factor for the asset, which is multiplied by the assets reproduction costs. This results in an asset's Fair Value.

5.23 In applying the age/life approach, we applied a 10% floor to the values, reflecting the fact, that under the premise of continued use, the assets retain some value to the ongoing operation of the business.

5.24 An asset's residual, or floor value is an estimate of its value as it approaches the end of its useful life, however is maintained in regular operation with no immediate plan for itsremoval. This concept reflects the commonly accepted valuation principle that as long an asset is used as part of an enterprise, it has a value to that enterprise.

5.25 This residual value reflects the estimated costs of replacing the asset, with one of comparable vintage and condition, and includes consideration for freight and installation. When valuing assets regularly traded on the secondary market, this value is relatively easy to both discern, and document.

5.26 When valuing assets such as telephone switches and related equipment, which do not have the measurable market that some other asset groups possess, an estimate is necessary. This estimate of value is based on a percentage of the asset's reproduction cost.

5.27 Common valuation practice clearly indicates that this percentage ranges anywhere from five to twenty-five percent of an asset's reproduction cost, depending on several factors, including the anticipated future use of this asset by its owner, and/or how much longer will this asset be a part of the business enterprise.

5.28 Floor values of twenty percent are often used for regular or special type assets. This floor is applied, under the assumption that there are no specific plans to remove the asset and that they will remain in place for as long as it is economically feasible to operate them. The most common source for twenty percent floors is Marshall & Swift's Marshall Valuation Services manual, published annually.

5.29 However, when the owner’s intent is to remove the asset from service, an adjustment is usually made to reflect the asset’s diminished value as a result of its shortened life. In applying the age/life approach, we applied a 10% floor to the values, reflecting that under the premise of continued use, the assets retain some value to the ongoing operation of the business, however acknowledging the stated intention of the owner to remove these assets from service before normally expected.

5.30 Although there was no substantial evidence of sales of used equipment, in the market, within Israel, we were able to note that Pelephone has sold equipment, obtaining anywhere from 0.37% to 6.67% of reproduction cost. These used equipment sales were taken from Pelephone as offered, and not confirmed by us in any manner. Based on a simple average of this sale cost, (say4.5%) and assuming that on top of this cost would be those costs for freight and installation, we believe that a 10 percent floor value is reasonable for equipment still operating within the business of Pelephone.

5.31 The used asset sales made by Pelephone were immaterial in terms of Pelephone’s equipment base, and should not be considered a representative sample.

5.32 As part of our engagement we reviewed the sensitivity of the valuation to the floor value assumption and confirmed that the elimination of the floor value would result in an immaterial change in value.

5.33 The sensitivity of the valuation to changes in the floor value assumption is as follows:

0%	1,260,577,330

5%	1,260,827,330
10%	1,261,075,330*
15%	1,261,391,330
20%	1,261,724,330

* Value Concluded

5.34 As part of our effort, we visited thirty-one Pelephone equipment sites. The assets at these sites accounted for over fifty percent of the overall Fair Value of the assets. The purpose of this visit was to: 1) confirm the existence of major assets, 2) inspect the facility for overall condition, and 3) establish the utility of the assets. Our inspection revealed all major assets to be accounted for with the appearance of all being in good condition and fully utilized.

5.35 The remaining locations were not visited and, therefore, we cannot accept responsibility for the accuracy of the records upon which our studies are based. We have assumed they are a reasonable representation of the facts.

6. Conclusion

6.1 Based upon the investigation described herein, it is our opinion that the Fair Value of the subject Assets, as of 1 January 2005, is reasonably represented in the amount of: **1,261,075,330** NIS (ONE BILLION TWO HUNDRED AND SIXTY-ONE MILLION SEVENTY FIVE THOUSAND THREE HUNDRED THIRTY NEW ISRAELI SHECKELS).

6.2 This report is prepared in accordance with, and subject to, our General Service Conditions and Assumptions and Limiting Conditions which form part of this letter.

6.3 Unless the facts and circumstance suggested otherwise, our opinion of Fair Value was prepared on the basis of continued use. Accordingly, we have assumed that the Assets will continue to be used in the ongoing business of Pelephone, and this opinion of value does not represent the amount that might be realised from the piecemeal disposition of the assets in the open market.

6.4 This opinion of Fair Value has been prepared under the assumption that the earnings of the operation in which the Assets are utilised will be adequate to justify ownership of the Assets appraised.

6.5 We have not investigated the title to, or any liabilities against, the property appraised and no responsibility is assumed for these matters.

6.6 We hereby certify that we have neither a present nor a prospective interest in the Company, the Assets appraised or the value reported.

Appendix A – Information Received

1. Pelephone's Equipment List 10/01/07" Excel file, provided to us by Pelephone.

2. Access to relevant data of the main supply contracts with Motorola and Nortel

3. Access to summary data concerning transactions of second hand equipment

Appendix B – General Service Conditions

Agreement – The Contract governing this engagement including these General Service Conditions represents the entire agreement between American Appraisal and the Client. It supersedes any prior oral or written agreement and may not be altered except by the mutual written agreement of all parties thereto.

Assignment – Neither party may assign, transfer, or delegate any of the rights or obligations hereunder without the prior written consent of the other party; unless such assignment is based upon the lawful transfer to a successor in interest of all or substantially all of the party's assets or business interests.

Client of Record – Only the signed Client(s) of Record may rely on the results of American Appraisal's work. No third party shall have the reliance or contractual rights of American Appraisal's Client(s) of Record without American Appraisal's prior written consent. No party should rely on the results of American Appraisal's work as a substitute for its own due diligence.

Communication – Electronic media including voice-mail, e-mail, and faxes are acceptable vehicles to communicate all materials unless such communication forms are expressly prohibited in the Contract. Client shall not assume or deem the Client Service Team assigned by American Appraisal to any work contemplated by the Contract to have knowledge of information provided to others not part of that team.

Contingent Fees – American Appraisal's compensation is not contingent in any way upon its opinions or conclusions or upon any subsequent event directly related to those opinions or conclusions. Client shall pay American Appraisal's invoices in accordance with their stated terms.

Confidentiality – American Appraisal will maintain the confidentiality of the Client's confidential information with the same degree of care that American Appraisal uses to keep its own materials confidential, and in any event, the degree of care shall be reasonable, and shall not disclose it to anyone or use it for any purpose whatsoever other than Client's engagement, provided that in the event that American Appraisal is legally compelled to disclose such information, American Appraisal shall provide Client with prompt written notice so that Client may seek a protective remedy, if available. Any such access shall

continue to be subject to the same confidence by both American Appraisal and the applicable organization. Information shall not be treated as confidential if: (i) it is now or later available to the public, (ii) at the time of disclosure to American Appraisal, the information was already in its possession, or (iii) the information was obtained from a third party under no obligation of confidentiality to Client.

American Appraisal shall have the right of review, in advance of the publication of any document in which its report is either referenced or disclosed, in full or in part.

American Appraisal shall have the right to include Client's name in American Appraisal's client list.

Force Majeure – Neither the Client nor American Appraisal shall be liable for delays or for failures to perform according to the terms of the Contract due to circumstances that are beyond their individual control.

Governing Law, Jurisdiction and Venue – This Contract shall be governed by Israeli Law within the jurisdiction of any court located in Israel, having subject matter jurisdiction.

Indemnification – Client shall indemnify American Appraisal for all reasonable attorneys' fees, that American Appraisal incurs as a result of becoming part of, or named in, an administrative or legal dispute in connection with this Engagement, except to the extent caused by American Appraisal's negligence or misconduct. Client shall have the right to approve or appoint American Appraisal's counsel in any such proceeding.

American Appraisal shall indemnify and hold harmless Client against and from any and all losses, claims, actions, damages, expenses or liability, including reasonable attorneys' fees, to which Client may become subject in connection with this engagement, and which are a direct result of American Appraisal's negligent or wilful act or omission

While on Client's premises, the personnel assigned by American Appraisal to any work contemplated by the Contract shall comply with all posted safety instructions or safety procedures requested by Client.

Independent Contractor – American Appraisal and Client shall be independent contractors with respect to each other. American Appraisal reserves the right to use subcontractors in executing the engagement. All subcontractors employed on this engagement will be subject

to the same non-disclosure obligations as American Appraisal. American Appraisal is an equal opportunity employer. Subcontractors are defined herein as persons not employed by any companies within the American Appraisal or BDO networks. Subcontractors will not be used on this project without the prior written approval of Client.

Limits on the Use of the Work – American Appraisal's report may be used only for the specific use or uses stated in the Contract, and any other use is invalid.

Reliance on Information Provided by Client – American Appraisal is entitled to rely without independent verification on the accuracy and completeness of all of the information provided by Client or its advisors.

Retention – Unless stipulated to the contrary in the Contract or in a related written agreement, the Client shall have all proprietary rights in and to all files, documents, workpapers, and other results, developed during the course of the engagement ("Materials"). Unless requested otherwise by the Client, the materials will be retained by American Appraisal for a period of at least 7 years. During this retention period, Client shall have access to the Materials to assist it in completing the specific use or uses stated in the Contract, subject only to reasonable notification. Following the retention period, the Materials shall be forwarded to the Client or destroyed, as per the Client's request.

Scope of the Work – American Appraisal shall be obligated only for services specified in the Contract, and only for changes to the scope of those services that are set forth in any subsequent written agreement. As a result, the scope of the work does not include unrelated services or the responsibility to update any of the work after its completion. Further, American Appraisal reserves the right to decline to perform any additional services, if American Appraisal believes such services would create an actual or perceived conflict of interests, or would be illegal or in violation of applicable regulations or professional standards.

Standards of Performance – American Appraisal shall perform the engagement in accordance with applicable professional standards. However, professional services usually involve judgements made in an uncertain environment and based on an analysis of data that may be unverified or subject to change over time. Client and other parties to whom Client provides access to the results of American Appraisal's work shall evaluate the performance of

American Appraisal based on the specifications of the Contract as well as on the applicable professional standards.

Testimony – American Appraisal's services do not include giving testimony or participating in or attending court or any other legal or regulatory hearing or inquiry. American Appraisal shall however participate or attend court or any legal or regulatory hearing or inquiry in connection with the services under the Contract and that Pelephone (or Bezeq) shall pay an amount as agreed by the parties in connection with such participation. Our fees for such services will be as follows: American Appraisal: US$300 per hour plus VAT and out of pocket expenses; BDO partner: US$120 per hour plus VAT; BDO senior manager: US$90 per hour plus VAT.

No Conflict of Interests – American Appraisal hereby represents that there is no conflict of interests between carrying out its obligations under this Contract and any other obligation or interest of American Appraisal. Should there be a possibility of such conflict of interests, American Appraisal shall notify immediately to the Client. The client shall be entitled, under these circumstances, to terminate immediately the Contract and/or any other measure in order to protect its rights.

Appendix C – Assumptions and Limiting Conditions

This service was performed with the following general assumptions and limiting conditions:

1. To the best of our knowledge, all data, including historical financial data, if any, relied upon in reaching opinions and conclusions or set forth in this report are true and accurate. Although gathered from sources that we believe are reliable, no guarantee is made nor liability assumed for the truth or accuracy of any data, opinions, or estimates furnished by others that have been used in this analysis.

2. No responsibility is assumed for matters legal in nature. No investigation has been made of the title to or any liabilities against the property appraised. We have assumed that the owner's claim is valid, the property rights are good and marketable, and there are no encumbrances that cannot be cleared through normal processes, unless otherwise stated in the report.

3. The value or values presented in this report are based upon the premises outlined herein.

4. The date of value to which the conclusions and opinions expressed apply is set forth in the report. The value opinion presented therein is based on the status of the economy and on the purchasing power of the currency stated in the report as of the date of value (January 1st 2005).

5. This report has been made only for the use or uses stated, and it is neither intended nor valid for any other use.

6. Possession of this report or any copy thereof does not carry with it the right of publication. No portion of this report (especially any conclusion, the identity of any individuals signing or associated with this report or the firms with which they are connected, or any reference to the professional associations or organizations with which they are affiliated or the designations awarded by those organizations) shall be disseminated to third parties through prospectus, advertising, public relations, news, or any other means of communication without the written consent and approval of American Appraisal.

7. Areas, dimensions, and descriptions of property, if any, used in this analysis have not been verified, unless stated to the contrary in the report. Any areas, dimensions, and descriptions of property included in the report are provided for identification purposes only, and no one should use this information in a conveyance or other legal document. Plats, if any, presented in the report are intended only as aids in visualizing the property and its environment. Although the material was prepared using the best available data, it should not be considered as a survey or scaled for size.

8. Unless stated to the contrary in the report, no environmental impact study has been ordered or made. Full compliance with all applicable laws and governmental regulations is assumed unless otherwise stated, defined, and considered in the report. We have also assumed responsible ownership and that all required licenses, consents, or other legislative or administrative authority from any applicable government or private entity organization either have been or can be obtained or renewed for any use that is relevant to this analysis.

9. The value estimate contained within the report specifically excludes the impact of substances such as asbestos, urea-formaldehyde foam insulation, other chemicals, toxic wastes, or other potentially hazardous materials or of structural damage or environmental contamination resulting from earthquakes or other causes, unless stated to the contrary in the report. It is recommended that the reader of the report consult a qualified structural engineer and/or industrial hygienist for the evaluation of possible structural/environmental defects, the existence of which could have a material impact on value.

Appendix D – Resumes of Senior Team Members

Ian W. Gough
Managing Director, Industrial Valuation
American Appraisal (UK) Ltd

Position

Ian Gough is the Managing Director of American Appraisal's Industrial valuation practice in the UK. In addition to operating in his management role, Ian Gough acts as a Managing Consultant, managing multidisciplined and multinational valuation and consulting engagements

Experience

Business

For several years prior to joining American Appraisal, Ian Gough was employed as a consultant by one of the world's leading firms of chartered accountants.

Additionally Mr Gough has experience in the management construction projects, gained with a regional public body and a major utility.

Valuation

Since joining American Appraisal, Mr Gough has been involved in the valuation of a diverse range of businesses and asset types, encompassing industrial and commercial property, machinery and equipment as well as intangible assets and the total business enterprise.

Mr Gough's consulting expertise encompasses a wide variety of industry sectors including: chemical, petrochemical, transportation, packaging, paper, engineering, food and drink, telecommunications, hi tech manufacturing, leisure and utilities.

In the 17 years that he has been with the firm, Ian Gough has undertaken valuations for a wide variety of purposes including: mergers and acquisitions, allocation of purchase price, financial reporting, taxation, purchase & sale, financing, and privatisation purposes.

Mr. Gough has undertaken and managed valuation and consulting engagements on 4 continents and has provided appraisal services in more than 25 countries.

Education

BSc (Hons) Civil Engineering

Professional Affiliations

FRICS	Fellow of the Royal Institution of Chartered Surveyors
MACostE	Member of the Association of Cost Engineers
	Graduate of the Institute of Civil Engineers

Member of the European American Tax Institute
Member of the Institute of Directors

Publications/Speeches

"Valuation – Meeting the needs of the global investor" Article in Property Forecast

"Managing the Appraisal Process/The Role of an Appraisal Firm" Lectures to MBA students, University of Exeter

"Appraisal in the Emerging Markets of E. Europe" articles in American Chamber of Commerce Newsletters

"Incorporating Risk into the Valuation of High Tech Assets" Conference Presentation, London

Specific Telecommunications Experience

Atlas Online	Pre IPO valuation of a Turkish Internet Service Provider
Belgacom	Valuations of Various equipment assets (fixed and mobile) for the Belgian state telecommunications operator for sale/leaseback.
British Telecom	Valuation of various network assets for structured financing *(Project Review Authority, UK)*
Eircom	Valuations of Irish telecom network equipment for leasing. Valuation of the business units of the Irish landline operation for purchase price allocation. *(Project Director)*
France Telecom	Pre IPO study of "Orange" Mobile Network in UK for France Telecom following its acquisition of the business. *(Project Director)*
GPT	Valuation of network assets for financial reporting in advance of privatization. (*Project Director)*
GTS	Numerous valuations of networks and operations around Europe for restructuring. *(Project Director, European Assets)*
Lattice Telecoms	Valuation of the broadband telecoms assets of a UK utility provider for restructuring. *(Project Director)*
MCI Worldcom	Valuation of Pan European and transatlantic networks for internal restructuring. *(Project Director)* Valuation of worldwide assets for the planned emergence of the company from bankruptcy. *(Project Review Authority, European Fixed Assets)*

OTE	Valuation of Tangible assets in connection with the privatisation of Greek Telephone Network.
O2	Valuation of various network assets for tax planning. *(Project Director)*

Daniel D Zoller Jr., ASA

Managing Director and Vice President,
Industrial Valuation Group

Position

Daniel D Zoller Jr is the managing director of the Atlanta Industrial Valuation Group of American Appraisal Associates, Inc.

Experience

Valuation

Mr Zoller has provided appraisal services to determine fair market value for allocation of purchase price; liquidation and auction values for financing; retrospective cost analysis for recapture studies; insurance values; residual and terminal leasing values; and review and valuation for ad valorem tax purposes.

Mr Zoller has completed valuation assignments in a variety of industries, including metalworking; mining; petrochemicals; electronics; high technology and telecommunications; food processing; general manufacturing; textiles; and diagnostic, rehabilitative, and general health care. He also has extensive asset-based appraisal experience through his work in the banking industry and has completed joint venture valuations for both domestic and international operations. Most recently, Mr Zoller has been involved in significant ad valorem tax valuations. In addition, he has completed major international valuation assignments in Brazil, Mexico, Jamaica, and Puerto Rico.

Court

Mr Zoller has qualified as an expert witness in bankruptcy and/or tax courts in Florida, Georgia, Louisiana, and North Carolina.

Business

Prior to rejoining American Appraisal in 2000, Mr Zoller had been with American Appraisal from 1988 through 1992. He has served in staff, senior, and managerial appraisal positions.

Mr Zoller has 30 years of experience in heavy construction projects and in industrial valuations. He was involved in major infrastructure projects in the Mideast, where he developed expertise in construction cost, budgeting, planning, and forecasting. Mr Zoller has experience in the sale, rental, and leasing of heavy construction and industrial equipment in domestic positions. He has also taught college-level courses in various subjects.

Education

Central Michigan University
Master of Science
Pennsylvania State University
Bachelor of Arts

Professional Affiliations	American Bankruptcy Institute, Member American Society of Appraisers, Accredited Senior Appraiser: Machinery and Technical Specialties/Machinery and Equipment Region 2 District Director Atlanta Chapter Distinguished Member Award, 2001 President, 2002-2004 Senior Vice President, 2001-2002 Vice President, 1998-1999 Institute for Professionals in Taxation, Member International Association of Assessing Officers, Associate Member
Valuation and Special Courses	Ad Valorem Valuation Appraisal of Inventory Business Enterprise Valuation Civil Construction and Architectural Component Valuation Techniques Cost Segregation Seminar Current Cost Development for Risk Management and Coinsurance Financial Valuation Theory Fixed Asset Accounting Fundamentals of Real Property Appraisal Income Approach to Value Intangible Asset Valuation Theory Personal Property Valuation/Assessment Uniform Standards of Professional Appraisal Practice
Speeches	"Valuation of Machinery and Equipment Under FAS 144" "Methods for the Valuation of Idle Equipment for Ad Valorem Tax Purposes" "Expert Witness Testimony: Different Approaches" "Amoco vs. Forsyth County, Georgia"

Cynthia N White, ASA
Consultant, Industrial Valuation Group

Position	Cynthia N White is a consultant for the Atlanta Industrial Valuation Group of American Appraisal Associates, Inc.
Experience	
Valuation	Ms White values fixed assets, and has developed their cost of reproduction new, cost of reproduction new less depreciation, fair value and fair market value under the premise of continued use, orderly liquidation value, and auction value for purposes including insurance, purchase price allocation, financing, and financial reporting. She has served the metalworking, manufacturing, information technology, chemical, printing, textiles, and retail industries.
Business	Ms White joined American Appraisal in 1990. With a background as an appraisal administrator, she became an associate appraiser and was promoted to her current position in 2006.
Professional Affiliations	American Society of Appraisers, Accredited Senior Appraiser: Machinery and Technical Specialties/Machinery and Equipment Atlanta Chapter Secretary, 2004-Present
Valuation and Special Courses	Introduction to Machinery and Equipment Machinery and Equipment Valuation Methodology Machinery and Equipment Valuation - Advanced Topics and Case Studies Machinery and Equipment Valuation - Advanced Topics and Report Writing Uniform Standards of Professional Appraisal Practice Machinery Identification Conference, October 2001 Valuation of Machinery and Equipment - Advanced Concepts Finance and Accounting for Non-Financial Managers

Pini Schmeuli Nissan
Partner
BDO Consulting Group

Position Pini Shmueli-Nissan is a Partner with BDO Ziv haft Consulting Group, in Tel-Aviv

Experience
Business

Mr. Shmueli-Nissan is highly experienced in economic and strategic consultant to various industries, specializing in the technology industry and the telecommunications and internet sectors. Mr. Shmueli-Nissan is responsible for numerous comparative research opinions and valuations in the field.

Mr. Shmueli-Nissan has been involved in several significant procedures in the telecommunication area, including, inter alia, Bezek's privatization and the competitive implementation in the communication market.

He has accompanied a large number of public and private issues, and consults many technology companies in merger and acquisition transaction.

Mr. Shmueli-Nissan has consulted a number of local telecommunication companies, such as Matav and Barak. Pini headed a number of telecommunications and internet research projects for the Israeli Ministry of Communications, Israeli banks and other Israeli institutions.

Mr. Shmueli-Nissan managed the research and consulting department of Foresight Investments & Technological Research for four years. Previous to that, Mr. Shmueli-Nissan headed the corporate finance division of Ernst & Young (Israel) for two years. In both positions, he had directed a large number of valuation projects for the biggest public companies in Israel such as Israel Chemicals and private companies such as Partner and Yes.

He has also established cost accounting system for the air fields authority and Israel Railway.

Education Mr. Shmueli-Nissan holds an M.A. in Economics and business Administration from Tel Aviv University.

BA program, Faculty of Social Arts, Ben Guryon University, Economics and Accountancy

Nir Peles, CPA, MBA, MA$_{\text{(Law)}}$
Senior Manager
BDO Consulting Group

Position Nir Peles is a Senior Manager with BDO Ziv haft Consulting Group, in Tel-Aviv

Experience Mr Peles is a corporate finance senior manager, his department consists of seven consultants, all of them dealing mainly with corporate finance.

Mr Peles joined BDO in 2005 after having worked as a business advisor for 5 years at a leading economic consultants firm, where he specialized in evaluations, expert opinions, economic opinions, financial statements analysis and business analysis. Previous to that he worked 3 years as an interne and auditor in Israel's largest accounting firms.

Mr Peles has managed and performed hundreds of economic consulting projects in his field of expertise, including valuation of public companies needed for M&A, expert opinions, fairness opinions, purchase price allocation appraisal, Stock options valuation, Economic and accounting Due Diligence, Equity research – on going coverage of 25 Israeli technological public companies, for the needs of Institutional Investors, Financial statements analysis, business analysis and financial consultancy on various economic issues, Business valuations of private companies and relate topics.

Education MA program, Faculty of Law, Bar Ilan University.
MBA program, The Leon Recanati Graduate School of Business Administration, Tel Aviv University, Major in Corporate Finance.
BA program, Faculty of Social Arts, Hebrew University in Jerusalem, Economics and Accountancy

Published Articles Mr Peles's seminar in economics, research into the macro-economic effects of car thefts in Israel, written together with a colleague, was published by the Israeli Quarterly Revue of Taxes, July 1998.
Mr Peles's review of the Israeli capital markets and the different opportunities of private companies to have their Initial Public Offering in Tel Aviv Stock Exchange was published recently in "Globs".

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22/03/2007

Danny Oz, Accountant
Bezeq, the Israeli communication company

Subject – Bezeq's Copper wires valuation

Background

Bezeq is currently conducting a feasibility test for the transition to NGN (Next Generation Network), which is based on Optic fibers and expected to replace the existing large copper pair cable from the Local Access Switch to the first cross connect point (Main network). Even so, the medium to small copper pair cable from the first cross connect point to the customer premises (Distribution network) is expected to remain in the foreseeable future. As part of the NGN feasibility test, a question was raised regarding the value of Bezeq's Main network.

The copper wires value, after their scraping from Bezeq's network, is based mainly on the world copper price and presents the copper's sale value as raw material, after ceasing its use as a communication cable. Simultaneously, considering the predicted substantial residual value of the copper wires and the new release of IAS 16, as part of the adoption of IFRS, Bezeq is required to re-evaluate the residual value of all existing copper wires networks (Main and Distribution), for bookkeeping purposes.
Bezeq has turned to TASC in order to evaluate the expected economic value from selling the copper wires, as part of Bezeq's adjustments to IFRS.

Calculation Methodology

The calculation of the copper wires value was based on the copper value from 2004 and on, with the rise of the copper price in the world. The calculation was based on four main parameters –

1. The copper wires length – the calculation of the copper wires length in Bezeq was based on existing information from Bezeq's registration system, while considering the following issues:
   - Quality of the data in the registration system – the system has existed for 15 years and is currently being upgraded (the new system is supposed to be active towards the end of the year). In the last three years, the system went through a data improvement process, internal as well as external (in comparison to other systems like Menrav or Bezeq 1, which follow data on sales of services to customers). From 11 districts in Bezeq, 10 have finished

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the data conversion to the system by the end of 2004; while only the South district is still in the process of converting the data, and is due to convert another 30% of its data. The system produces quality reports every week and the deficiencies are corrected immediately. From a sample check of the data, it was found that in the subjects of the wires' existence and/or the wires' length there was a deviation of less then 1% between the different systems existing today. Another sample check, made on 2000 pairs' cables, was found intact in all aspects. Even so, the registration system holds no reliable information regarding the installation dates of the different cables – therefore it is not possible to produce any yearly data regarding the Main and Distribution networks.

- Bezeq's copper wire network is composed from two main types of cables: "Dry" thin coating cables (from the size of 100 pairs and up), and "wet" jelly coating cables (till a maximum size of 400 pairs). In general, the Main network is composed only from "dry" cables, while the Distribution network is composed from "wet" cables. Since the rule is that cables larger than 400 pairs are part of the Main network (apart from few exceptions), we assumed that every cable of 400 pairs and up is part of the Main network, while every cable under 400 pairs in part of the Distribution network (the overlap in this area is insignificant).

2. Weight per Km – the different cables' weight is based on existing information from the Access Networks department in Bezeq, which collects the different physical information on the existing copper wires. The weight data (Kg/Km) were received in cross-section of cable type ("wet" or "dry"), number of pairs (5-2000) and conductor diameter (0.4-0.9 mm).
3. Safety factors – two factors that reflect conservativeness were taken into account in the calculation –
   - Data quality factor
   - Copper loss factor
4. Price per ton of cable – the Scraping Committee in Bezeq is responsible for selling copper cables to external contractors by tenders. The price per ton of copper, which the external contractor offers, is derived from the difference between the cable weight and the weight of the copper inside the cable (the coating is useless for the contractor); from the world copper price (after burning the coating, pure copper is left) and from the contractor's work costs (such as transportation, burning facility cost, etc.). in order to calculate the price for a ton of copper, we derived the following equation:

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$$P(cable) = a*P(copper)-b$$

When:

P(cable) – The price per ton of cable

P(copper) – The copper price in the LME (London Metal Exchange)

a - The average difference between the cable weight and the copper weight per Km

b – The contractor's work costs

Based on a number of recent Bezeq tenders, we managed to extract the estimated value of the contractor's work and the average difference between the cable weight and the copper weight per Km that the contractors take into account.

It's important to mention that the contractors are not aware of the size and the type of cables that they purchase in the tender; therefore the difference between the cable weight and the copper weight per Km that they consider is based on some average, with no correlation to the type or size of the cables that Bezeq actually offers. In addition, we estimate that the contractor's work costs per ton will decrease when the cable quantity will rise, but for conservative reasons we did not take into account any such decrease.

Calculations

For calculation purposes, a data quality factor for Bezeq's copper network was taken into account:

Calculation date	*Data quality factor*
31/12/2004	2%
31/12/2005	2%
31/12/2006	1%

The calculation outcome of the network's total weight (Main and Distribution), including the adjusted calculation of the data quality factor, are presented in the following tables (appendixes A-C contain detailed data regarding the network's distribution by cable size):

Main Network -

Value Calculation Date	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
31/12/2004	21,927	30,240	73%
31/12/2005	22,593	31,201	72%
31/08/2006	23,355	32,273	72%

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Distribution Network –

Value Calculation Date	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
31/12/2004	8,645	18,158	48%
31/12/2005	9,172	19,264	48%
31/08/2006	9,553	20,072	48%

In addition, there exists a possibility of "losing" some of the copper in the scrapping process (especially in large quantities), and therefore we took into account a 2% copper loss factor for the main network.

Based on the recent Bezeq's copper tenders, we derived the following figures:

1. The average difference between the cable weight and the copper weight per Km - 61.79%
2. The contractor's work costs – 4,837 NIS per ton

The copper price for the calculation was based on the LME copper price:

Value Calculation Date	*Copper Price ($)*	*Copper Price (NIS)**	*Price Per Ton of Cable (NIS)*
31/12/2004	$3,280	14,130 NIS	NIS 3,894
31/12/2005	$4,585	21,105 NIS	8,204 NIS
31/12/2006	$6,280	26,533 NIS	11,588 NIS

* The NIS price is based on the calculation date exchange rate (as published by the Bank of Israel).

Results

Based on the above calculation, it was found that Bezeq's copper wires value is as follows:

Value Calculation Date	*Main Network*	*Distribution Network*	*Total*
31/12/2004	115,403,148 NIS	70,710,263 NIS	186,113,411 NIS
31/12/2005	250,841,044 NIS	158,031,358 NIS	408,872,402 NIS
31/12/2006	365,540,793 NIS	231,990,337 NIS	597,531,130 NIS

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It is necessary to mention that the price per ton of copper is conservative and does not include any negotiation between Bezeq and the contractor, which may lead to a higher price due to a reduction in the contractor's work costs.

Best regards,

Ilan Schory
Senior Partner
TASC

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Appendix A – cable size distribution (31/12/2004)

Main Network -

Copper Size (pairs)	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
400	3,225	5,570	58%
450	1,274	1,557	82%
600	1,215	1,644	74%
800	3,107	4,154	75%
900	996	1,251	80%
1000	198	262	75%
1200	2,810	3,739	75%
1400	97	130	74%
1600	595	792	75%
1800	460	612	75%
2000	7,950	10,528	76%
Total	**21,927**	**30,240**	**73%**

Distribution Network -

Copper Size (pairs)	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
5	17	78	21%
6	0	0	27%
10	193	734	26%
11	0	1	26%
15	23	86	27%
16	1	3	26%
20	313	933	34%
25	34	99	35%
26	1	2	33%
30	262	688	38%
50	805	1,923	42%
100	2,142	4,472	48%
200	4,612	8,765	53%
300	242	375	65%
Total	**8,645**	**18,158**	**48%**

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Appendix B – cable size distribution (31/12/2005)

Main Network -

Copper Size (pairs)	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
400	3,418	5,900	58%
450	1,323	1,622	82%
600	1,305	1,764	74%
800	3,198	4,276	75%
900	1,005	1,262	80%
1000	198	262	75%
1200	2,873	3,823	75%
1400	97	130	74%
1600	613	817	75%
1800	462	614	75%
2000	8,102	10,729	76%
Total	**22,593**	**31,201**	**72%**

Distribution Network -

Copper Size (pairs)	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
5	19	90	21%
6	0	0	27%
10	204	776	26%
11	0	1	26%
15	24	88	27%
16	1	3	26%
20	331	986	34%
25	35	101	35%
26	1	2	33%
30	281	735	38%
50	855	2,041	42%
100	2,282	4,760	48%
200	4,891	9,296	53%
300	248	384	65%
Total	**9,172**	**19,264**	**48%**

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Appendix C – cable size distribution (31/12/2006)

Main Network -

Copper Size (pairs)	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
400	3,543	6,126	58%
450	1,361	1,669	82%
600	1,352	1,828	74%
800	3,342	4,472	75%
900	1,040	1,306	80%
1000	204	270	75%
1200	2,975	3,960	75%
1400	98	132	74%
1600	641	854	75%
1800	467	622	75%
2000	8,333	11,034	76%
Total	**23,355**	**32,273**	**72%**

Distribution Network -

Copper Size (pairs)	*Total Copper Weight (Ton)*	*Total Cable Weight (Ton)*	*% Copper*
4	0	0	27%
5	21	98	21%
6	0	0	27%
10	214	813	26%
11	0	1	26%
15	24	90	27%
16	1	3	26%
20	345	1,029	34%
25	36	104	35%
26	1	3	33%
30	295	770	38%
50	895	2,135	42%
100	2,382	4,968	48%
200	5,088	9,666	53%
300	252	391	65%
Total	**9,553**	**20,072**	**48%**

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Appendix D – Copper price

Copper price table for the last five years (28/09/2001 – 31/12/2006):

Date	Copper Price ($)
28.12.2001	1,462
30.01.2002	1,502
28.02.2002	1,539
28.03.2002	1,623
26.04.2002	1,599
31.05.2002	1,629
28.06.2002	1,654
31.07.2002	1,511
30.08.2002	1,500
30.09.2002	1,435
31.10.2002	1,536
29.11.2002	1,626
31.12.2002	1,536
31.01.2003	1,714
28.02.2003	1,716
31.03.2003	1,588
30.04.2003	1,604
30.05.2003	1,683
30.06.2003	1,644
31.07.2003	1,769
29.08.2003	1,746
30.09.2003	1,794
31.10.2003	2,057
28.11.2003	2,074
31.12.2003	2,321
30.01.2004	2,489
27.02.2004	2,987
31.03.2004	3,068
30.04.2004	2,752
28.05.2004	2,831
30.06.2004	2,665
30.07.2004	2,900
31.08.2004	2,847
30.09.2004	3,140
29.10.2004	2,951
30.11.2004	3,262
31.12.2004	3,280
31.01.2005	3,276
28.02.2005	3,405

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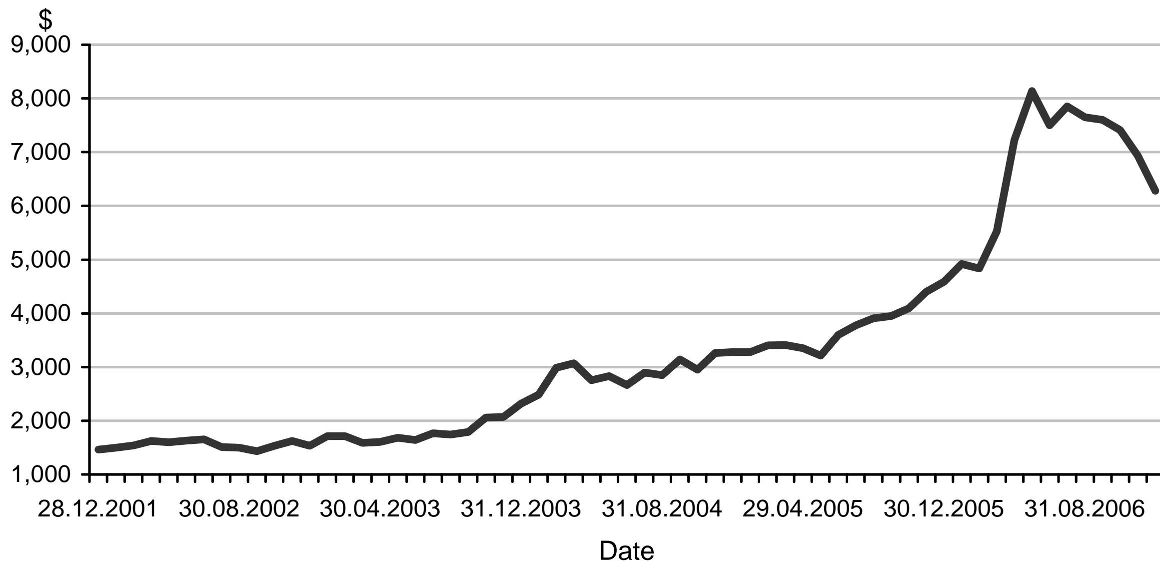
31.03.2005	3,408
29.04.2005	3,349
31.05.2005	3,214
30.06.2005	3,597
29.07.2005	3,775
30.08.2005	3,910
30.09.2005	3,949
31.10.2005	4,091
30.11.2005	4,405
30.12.2005	4,585
31.01.2006	4,920
28.02.2006	4,839
31.03.2006	5,528
28.04.2006	7,230
31.05.2006	8,140
30.06.2006	7,501
31.07.2006	7,851
31.08.2006	7,647
29.09.2006	7,601
31.10.2006	7,410
30.11.2006	6,936
29.12.2006	6,280

Copper price development (2001-2006, end of the month prices)



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Appendix E – Sensitivity Analysis

In order to review the main influences on the copper wires value, a sensitivity analysis was done on the main parameters and their influence on the value in 2006:

1. Contractor's work costs

Change in Contractor Cost	Cost (INS)	Main Network Value	Distribution Network Value	Total Value
80%	3,870	396,124,448 NIS	251,400,242 NIS	647,524,690 NIS
90%	4,353	380,848,434 NIS	241,705,326 NIS	622,553,760 NIS
100%	4,837	365,540,793 NIS	231,990,337 NIS	597,531,130 NIS
110%	5,321	350,233,152 NIS	222,275,348 NIS	572,508,500 NIS
120%	5,804	334,957,139 NIS	212,580,431 NIS	547,537,570 NIS

2. Data quality factor

Data quality factor	Main Network Value	Distribution Network Value	Total Value
100%	NIS 369,233,125	234,333,673 NIS	603,566,798 NIS
99%	NIS 365,540,793	231,990,337 NIS	597,531,130 NIS
98%	NIS 361,848,462	229,647,000 NIS	591,495,462 NIS
97%	NIS 358,156,131	227,303,663 NIS	585,459,794 NIS

3. Copper loss factor

Copper loss factor	Main Network Value	Distribution Network Value	Total Value
100%	NIS 373,000,809	231,990,337 NIS	604,991,146 NIS
99%	NIS 369,270,801	231,990,337 NIS	601,261,138 NIS
98%	NIS 365,540,793	231,990,337 NIS	597,531,130 NIS
97%	NIS 361,810,785	231,990,337 NIS	593,801,122 NIS
96%	NIS 358,080,777	231,990,337 NIS	590,071,114 NIS

TASC Strategic Consulting
1 Azrieli Center, Round tower, 25th floor, Box 91, Tel-Aviv, 67021, Israel
Phone: 972-3-6081688 Fax: 972-3-6081689
www.tasc-consulting.com

Appendix F – About TASC

TASC is an international strategic and financial consulting firm, which was founded in Israel in 1993 and based itself as the leading strategic, financial and organizational consulting firm in Israel. TASC employs 50 multi-disciplinary skilled professionals with a variety of backgrounds, including leading international consulting firms, communication, technology, finance, law, marketing, accounting and economics. TSAC supplies a variety of services in economic, strategic, and organizational fields, and specializes, among others, in the telecommunication sector.

In this field of expertise, TASC assists a variety of industry players, including: telecom groups, cellular operators, various TV players, equipment manufactures, market regulators and more. TASC has a rich experience and in-depth understanding of telecommunication technologies, expected developments in this sector, the Israeli market structure and its different characteristics compared with other countries.

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1 Azrieli Center, Round tower, 25th floor, Box 91, Tel-Aviv, 67021, Israel
Phone: 972-3-6081688 Fax: 972-3-6081689
www.tasc-consulting.com

Avi Ayash

Bezeq

Israel

March 30, 2007

Actuarial calculations in accordance with
International Financial Reporting Standard 19 *Employee Benefits*

Dear Sir/Madam,

You have asked us to provide a valuation of the post-employment benefit liability of Bezeq-Group in accordance with IAS 19 (revised 2004), for valuation dates 31st December 2004, 31st December 2005 and 31st December 2006.

Considering the following obligations, we have calculated the present value of the defined benefit obligation as of the dates listed above, and the current service cost for the financial years ending 31st December 2004, 31st December 2005 and 31st December 2006.

1. Benefit

1.1 Bezeq

1.1.1 Long Term Benefit liability

The calculations of this section of the report refer to the liability arising on utilization, redemption or realization of past-accrued benefits, but which are not necessarily a result of cessation of employment.

1.1.1.1 Accrued vacation days:

1.1.1.1.1 Employees have accrued vacation days, which are capped at maximum accrual of 75.5 days for permanent employees and as per the following table for temporary employees.

Years of service	Annual accrual	Maximum Accrual
1-4	12	14
5	14	14
6	17	16
7	19	20
8	20	25
9+	21.5	29

These vacation days can be utilized throughout the employment period or redeemed at the time of leave. All employees are entitled to redeem vacation days. The redemption is always for the full number of accrued days.

1.1.1.1.2 For vacation days, the redemption value is assumed to be the monthly salary for pension purposes divided by 20.83. The usage value is assumed to be the same, with an additional 27.51% factor to reflect social benefits and other costs.

1.1.1.1.3 For vacation days, negative balances were registered as asset. The assumption is that for the majority of cases, such negative balances are settled within a year of the valuation[1].

1.1.1.2 Accrued sick days:

1.1.1.2.1 All employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. For permanent employees, except "Dor 2000" and "Sechar Kollel" employees, if the sick days are not used up they can be redeemed at the time of leave (no matter what the circumstances of the leave, provided the employee is aged at least 55 on leave). The sick days for utilization are capped at 90 days for most employees (except "Sechar Kollel" and tenured employees for whom there is unlimited usage[2]), after which time some form of disability insurance becomes applicable.[3] Sick days for redemption purposes are not capped.

1.1.1.2.2 For employees who retire under selected tracks in the early retirement plan (see1.1.2) there is partial redemption of sick days from age 50-55, whereby the redemption is at 50% for age 50 and rises with each year of age to 100% at age 55 and above.

1.1.1.2.3 Accrual of sick days for tenured employees and Dirug 90 is 30 days per year, whilst for temporary employees it is 18 days per year.

1.1.1.2.4 The accrued sick days, if not used by the time the employee leaves the company, maybe redeemed at their redemption value, which depends on the employee's salary at the time of leave and the level of utilization of sick days throughout his employment history. A high level of utilization entitles him to a more limited or no redemption value. The following conversion table applies:

Utilization Level		For each 30 Accrued Days
From	To	
0%	35%	8 days
36%	65%	6 days
66%	100%	0 days

1.1.1.2.5 For sickness the redemption value for a each day is assumed to be the salary for pension purposes with the addition of the monthly "Havraah" amount, divided by 25, while the usage values is assumed to be the cost to employer each month divided by 25.

1.1.1.2.6 No negative balances for sick days were considered in the valuation.

1.1.2 Termination Benefits

The calculations of this section refer to the liability that has arisen from early retirement programs, which are special programs to make the company more efficient. A recent agreement was signed, which reflects an additional set of well-defined early retirement benefits in respect of 589 employees (including the additional full retirement elements – see 1.1.3.3 below).[4] The retirements fall under two tracks – a track for employees aged over 50

[1] One could argue that a settlement horizon of a year from valuation falls into the category of short term benefits and should possibly be registered as a short term asset outside this report, which only addresses long-term, termination, and post-employment benefits. However, the judgement on whether a benefit is included in the report or not was made based on the overall benefit provided by the company and not with regard to each employee seriatim.

[2] This does not currently affect the liability, see1.1.2 below.

[3] As the employee accrues future sick days, the utilization will increasingly be from these days (due to the "Last In, First Out" methodology prescribed by IAS 19), until after 5 years there is no more utilization liability.

[4] There is an additional population of employees who are entitled to retire with enhanced severance pay. However, there are no actuarial calculations needed for these employees, and the benefit is short-term, so this element is not included in our report.

and with a minimum of 20 years of service (hereafter 50/20) and a track for employees aged over 45 and with a minimum of 15 years of service (hereafter 45/15):

Employees who have already retired under the previous early retirement scheme are not included in this report.

1.1.2.1 Employees who have retired under the new early retirement scheme are included in the report.

1.1.2.2 Scheduled Retirees: there are 182 employees who have a scheduled retirement date falling after 1st January 2007.

1.1.2.3 Transferred employees:

1.1.2.3.1 Track 50/20 – 124 future retirements (of which 79 are in 2007 and 45 are in 2008)

1.1.2.4 Non-transferred employees

1.1.2.4.1 Track 50/20 – 175 future retirements (of which 142 are in 2007 and 33 in 2008)

1.1.2.4.2 Track 45/15 – 108 future retirements (of which 83 are in 2007 and 25 in 2008)

1.1.3 Post-employment benefit liability

The calculations of this section of the report refer solely to the liability arising on cessation of employment. Israeli labour laws and agreements require the company to pay severance pay to employees who reach full retirement age, who leave the company's employ under certain conditions (including termination of employment by the employer)[5], who die, or are disabled and unable to continue work. The calculation of the severance pay liability was made in accordance with labour agreement in force and based on salary components that in the management's opinion create entitlement to severance pay.

The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.

The liability for employee severance pay calculated here represents the unfunded balance of the total liability in respect of severance pay.

1.1.3.1 For most employees a § 14 Exemption applies. For employees with a § 14 Exemption we have calculated the liability for the period of service prior to the signing of the § 14 Exemption. The amount payable is one monthly salary for each year's employment (which is not subject to § 14 Exemption), based on the final salary prior to termination of employment[6].

1.1.3.2 Approximately 1,000 employees (see exact numbers in 2.1.1 below) have no § 14 Exemption, who are included in this report.

1.1.3.2.1 The amount payable is one monthly salary for each year's employment (which is not subject to § 14 Exemption), based on the final salary prior to termination of employment[7], net of the accrual balance in the severance pay fund.

1.1.3.2.2 For employees who choose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan and additionally supplements to the full severance pay amount. This forms a constructive obligation and as such is considered a liability under IAS 19.[8]

[5] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[6] As per Bezeq's directive, the last salary as of date of termination date is used and not the last salary as of the § 14 Exemption date.

[7] See footnote 6.

[8] As such, we have assumed that all leaves are with full severance pay. See actuarial assumptions below.

1.1.3.3 Full retirement for transferred employees offered as part of the 2006 early retirement agreement between Bezeq and its union. This is expected to affect a further 452 employees. For these employees, Bezeq will pay the difference between the civil service linked pension and the actual pension received from Makefet to the employee from retirement for the rest of their life.

1.1.3.4 Employees are also entitled to holiday gifts/bonuses, which are provided once a year to employees, retirees, and surviving spouses of employees or retirees. The benefits valued under these guidelines, only include the benefits in respect of post-employment gifts.[9]

1.1.3.5 In addition, pensioners and their spouses can attend clubs, which are maintained by Bezeq.

1.1.3.6 Finally, there is a budget for activities each retiree and their spouse are entitled to participate in.

1.1.4 Calculation Method

1.1.4.1 As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

1.1.4.2 The defined benefit obligation reflects the entitlement earned by active employees only.

1.1.4.3 As per IAS 19.102-4 the individual asset values have been calculated using a discounted cashflow approach.[10]

1.1.4.4 For the valuation of the early retirement benefit in as of 12/2004, the basis of the valuation is the prescribed methodology and assumptions for early retirement benefit purchases through the Makefet pension funds. This methodology was anchored at the time in a letter published by the Ministry of Finance in 1999. It was a conservative basis, which already reflected to some degree the need for covering some of the deficit that has accrued in the old pension funds and in various areas could have been considered economically unfavourable. However, since for Bezeq at the time the only possibility of meeting its contractual obligation towards his employees (union) was through the purchase of early retirement benefits from Makefet directly, Bezeq's management has informed me that the proper basis for appraising this liability is considering this contractual restriction.

1.1.4.5 Full Retirement Benefit: as per IAS 19 such benefit adjustments are considered recognition of past service cost. The liability is computed using the accrued pension percent as of the introduction of this benefit to reflect the past service cost. Since the benefit is not vested[11] until full retirement, as per IAS 19.96, the past service cost is spread over the average period until the benefit becomes vested. This period is 18.75 years, when weighting it for the past service cost.

1.2 Bezeq Senior

1.2.1 Long-Term benefit liability

The calculations of this section of the report refer to the liability arising on utilization, redemption or realization of past-accrued benefits, but which are not necessarily a result of cessation of employment.

1.2.1.1 Accrued vacation days:

1.2.1.1.1 Employees have accrued vacation days, which are capped at maximum accrual of 75.5 days. These vacation days can be utilized throughout the employment period or redeemed at the time of leave. All employees are

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[9] Holiday gifts payable to employees are an on-going cost.

[10] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

[11] *Vested employee benefits* are employee benefits that are not conditional on future employment.

entitled to redeem vacation days. The redemption is always for the full number of accrued days

1.2.1.1.2 For vacation days, the redemption value is assumed to be the monthly salary for pension purposes, divided by 20.83. The usage value is assumed to be the same, with an additional 27.51% factor to reflect social benefits and other costs.

1.2.1.1.3 Considering these obligations, we have calculated the present value of the defined benefit obligation as of the date listed above, and the current service cost for the financial years ending 31st December 2004, 31st December 2005 each quarter end of 2006.

1.2.1.1.4 For vacation days, negative balances were registered as asset. The assumption is that for the majority of cases, such negative balances are settled within a year of the valuation[12].

1.2.1.2 Accrued sick days:

1.2.1.2.1 All employees have accrued sick days, which can be utilized over the remainder of the employment when need arises and if the sick days are not used up they can be redeemed at the time of leave (no matter what the circumstances of the leave, provided the employee is aged at least 55 on leave).[13] Sick days for redemption purposes are not capped.

1.2.1.2.2 Annual accrual of sick days is 30 days per year.

1.2.1.2.3 The accrued sick days, if not used by the time the employee leaves the company, maybe redeemed at their redemption value, which depends on the employee's salary at the time of leave and the level of utilization of sick days throughout his employment history. A high level of utilization entitles him to a more limited or no redemption value. The following conversion table applies:

Utilization Level		For each 30 Accrued Days
From	To	
0%	35%	8 days
36%	65%	6 days
66%	100%	0 days

1.2.1.2.4 For sickness the redemption value for a each day is assumed to be the salary for pension purposes with the addition of the monthly "Havraah" amount divided by 25, while the usage values is assumed to be the cost to employer each month divided by 25.

1.2.1.2.5 No negative balances for sick days were considered in the valuation.

1.2.2 Post-employment benefit liability

1.2.2.1 The calculations of this section of the report refer solely to the liability arising on cessation of employment. Israeli labour laws and agreements require the company to pay severance pay to employees who reach full retirement age, who leave the company's employ under certain conditions (including termination of employment by the employer)[14], who die, or are disabled and unable to continue work. The calculation of the severance pay liability was made in accordance with labour

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[12] One could argue that a settlement horizon of a year from valuation falls into the category of short term benefits and should possibly be registered as a short term asset outside this report, which only addresses long-term, termination, and post-employment benefits. However, the judgement on whether a benefit is included in the report or not was made based on the overall benefit provided by the company and not with regard to each employee seriatim.

[13] As the employee accrues future sick days, the utilization will increasingly be from these days (due to the "Last In, First Out" methodology prescribed by IAS 19), until after 5 years there is no more utilization liability.

[14] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

agreement in force and based on salary components that in the management's opinion create entitlement to severance pay.

1.2.2.1.1 The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.

1.2.2.1.2 The liability for employee severance pay calculated here represents the unfunded balance of the total liability in respect of severance pay

1.2.2.1.3 The amount payable is one monthly salary for each year's employment (which is not subject to § 14 Exemption), based on the final salary prior to termination of employment[15], net of the accrual balance in the severance pay fund

1.2.2.1.4 Additionally, for employees who chose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan, if they own such a plan. This forms a constructive obligation and as such is considered a liability under IAS 19.

1.2.2.1.5 Additionally for senior employees, starting in the 3rd quarter of 2006, the company is obligated, whether contractually or constructively, to pay a multiple of monthly salary to the employee upon termination of employment for whatever reason (hereafter referred to as early notice). The multiple varies by employee (usually 3 or 6 months of salary).

1.2.2.1.6 The liability for employee severance pay calculated here represents the un-funded balance of the total liability.

1.2.3 Calculation method

1.2.3.1 As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

1.2.3.2 The defined benefit obligation reflects the entitlement earned by active employees only..

1.2.3.3 As per IAS 19.102-4 the individual asset values have been calculated using a discounted cashflow approach.[16]

1.3 Pelephone

1.3.1 Long-term benefit liability

1.3.1.1 All employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. However, the company does not offer a redemption option for un-used sick days.

1.3.1.2 All employees accrue vacation days, with the annual accrual being dependent on the individual employee's employment contract. These days can be utilised in the future, or redeemed, as the employee desires. The company has informed us that the cost of utilising or redeeming the vacation days is the same.

1.3.1.3 A few employees have a negative balance, which is recognized a negative liability, as the employees for the time being have to "pay back" the over-used vacation privilege. [17]

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[15] As per Bezeq's directive, the last salary as of date of termination date is used and not the last salary as of the § 14 Exemption date.

[16] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

[17] If an employee leaves with a negative balance, the company settles the open balance, just as it settles a positive balance with any employee terminating his service under whatever circumstances.

1.3.2 Post-employment benefit liability

1.3.2.1 Israeli labour laws and agreements require the company to pay severance pay to dismissed[18] or retiring employees (including those leaving their employment under certain other circumstances such as death or disability). The calculation of the severance pay liability was made in accordance with the agreements in force and based on salary components that in the management's opinion create entitlement to severance pay.

1.3.2.2 The company's severance pay liabilities to some of their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.

1.3.2.3 The amount payable is one monthly salary for each year's employment, based on the final salary prior to termination of employment, net of the accrual balance in the severance pay fund.

1.3.2.4 Additionally, for employees who chose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan, if they own such a plan (only 54 employees). This forms a constructive obligation and as such is considered a liability under IAS 19.

1.3.2.5 The company maintains separate bank deposits intended solely to cover any liabilities arising from employee's severance pay. These amounts are small and are not included in this report.

1.3.2.6 Lastly, the company offers to a selected number of employees an early notice benefit, whereby employees upon informing the company or being informed by the company of their forthcoming leave, the company in some cases provides one to six months of salary without the employees continuing his employment. This benefit is also paid upon retirement. This benefit was first introduced in the 3rd quarter of 2006.

1.3.2.7 The liability for employee severance pay calculated here represents the un-funded balance of the total liability.

Considering these obligations, we have calculated the present value of the defined benefit obligation as of the date listed above, and the current service cost for the financial years ending 31st December 2004, 31st December 2005 each quarter end of 2006.

1.3.3 Calculation method

1.3.3.1 As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

1.3.3.2 The defined benefit obligation reflects the entitlement earned by active employees only.

1.3.3.3 As per IAS 19.102-4 the individual asset values have been calculated using a discounted cash flow approach.[19]

1.4 Bezeq Int

1.4.1 Long-Term benefit liability

1.4.1.1 Vacation Days

1.4.1.1.1 Employees accrue vacation days, where the number of days varies by employee according to his employment years and contract. There is no cap on vacation accruals.

1.4.1.1.2 Generally employees have some accrued vacation day balance, which they are entitled to utilize or redeem at some point in the future. The utilization cost to the company includes social benefit costs plus additional employment related expenses, such as car maintenance.

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[18] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[19] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

Employees can also elect to redeem their accrued vacation days, in which case the company pays salary without the approximately 25% social benefit cost. However, this has been very uncommon and hence we assumed all days would be utilized.

1.4.1.1.3 A few employees have a negative balance, which is recognized a negative liability, as the employees for the time being have to “pay back” the over-used vacation privilege[20].

1.4.1.2 Sick Days

1.4.1.2.1 The company does not provide any option for redeeming the accrued unused sick days.

1.4.1.2.2 As the company’s employees are young and since there is no cap on accruing sick days, the liability – if any – for actual expected sick days is negligible and not computed for this report.

1.4.2 Post-employment benefit liability

1.4.2.1 Severance Pay

1.4.2.1.1 Israeli labour laws and agreements require the company to pay severance pay to dismissed[21] or retiring employees (including those leaving their employment under certain other circumstances such as death or disability). The calculation of the severance pay liability was made in accordance with the agreements in force and based on salary components that in the management’s opinion create entitlement to severance pay.

1.4.2.1.2 The company’s severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees’ names and by purchase of insurance policies. The company does not maintain a separate bank account intended solely to cover any liabilities arising from employee’s severance pay (Kuppa Merkasit LePitzuim).

1.4.2.1.3 The amount payable is one monthly salary for each year’s employment, based on the final salary prior to termination of employment, and depending on the personal agreement, usually net of the accrual balance in the severance pay fund. There are no exceptional employees, whose personal contract provides for a severance pay, which is a multiple for each year of service.

1.4.2.1.4 Additionally, for employees who chose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan, if they own such a plan. This forms a constructive obligation and as such is considered a liability under IAS 19.

1.4.2.1.5 The liability for employee severance pay calculated here represents the unfunded balance of the total liability.

1.4.2.2 Early notice: for senior employees the company provides a benefit of 3 months salary upon leave[22] of the employee irrespective if voluntary or by termination. Since the expected average life-time of senior employees per management’s assessment is two to three years, the impact of an actuarial valuation on this benefit (or the part of the benefit, which is post short-term benefit) is negligible when compared with the straight forward valuation methodology the company currently applies. Hence, this benefit is not included in this valuation and the reserve should be held according to current methodology (last salary x number of early notice months).

[20] If an employee leaves with a negative balance, the company settles the open balance, just as it settles a positive balance with any employee terminating his service under whatever circumstances.

[21] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[22] Generally, without providing any services to the company during this period.

1.4.3 Calculation method

1.4.3.1 As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

1.4.3.2 The defined benefit obligation reflects the entitlement earned by active employees only.

1.4.3.3 As per IAS 19.102-4 the individual asset values have been calculated using a discounted cash flow approach.[23] For Bezeq International we were informed that the insurance policies are credited with interest. This behaviour diverges from the standard past practice for these type of policies, which are generally not credited with interest, but instead the interest earnings are allocated to the non-severance part of the account.

1.5 YES

1.5.1 Long-Term benefit liability

1.5.1.1 Vacation Days

1.5.1.1.1 Employees accrue vacation days, where the number of days accrued each year varies by employee according to his/her contract and period of service (up to a maximum of 22 days per year). There is no limit as to the total number of days that an employee can accrue.

1.5.1.1.2 Generally employees have some accrued vacation day balance, which they are entitled to utilize or redeem at some point in the future. The utilization cost per day is calculated by the company as salary divided by 22. There is an additional cost for social benefits and taxes, which is estimated at 26% of salary for both utilization and redemption. Employees can also elect to redeem their accrued vacation days at any time, at the same cost to the company as utilization.

1.5.1.1.3 A few employees have a negative balance, which is recognized a negative liability, as the employees for the time being have to “pay back” the over-used vacation privilege.[24]

1.5.1.1.4 The company holds a provision for vacation day usage of senior management. This was supplied to us as a single figure, and has been added directly to the liability figures without our performing any actuarial calculations. Any change in the liability has been placed in the current service cost figure.

1.5.1.2 Sick Days

1.5.1.2.1 Employees accrue sickness days, where the number of days varies by employee according to his employment years and contract, according to the legal requirements in Israel. An employee can accrue up to 90 sick days.

1.5.1.2.2 Accordingly employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. The accrued sick days can be used upon an employee’s disability until he surpasses the waiting period or generally 90 days.

1.5.1.2.3 Employees are not entitled to redeem unused sick days at any time.

1.5.1.2.4 The cost to the company is the based solely on the salary of the employee and does not include any social or pension costs.

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[23] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

[24] If an employee leaves with a negative balance, the company settles the open balance, just as it settles a positive balance with any employee terminating his service under whatever circumstances.

1.5.2 Post-employment benefit liability

1.5.2.1 Severance Pay

1.5.2.1.1 Israeli labour laws and agreements require the company to pay severance pay to dismissed[25] or retiring employees (including those leaving their employment under certain other circumstances such as death or disability). The calculation of the severance pay liability was made in accordance with the agreements in force and based on salary components that in the management's opinion create entitlement to severance pay.

1.5.2.1.2 The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.

1.5.2.1.3 The company does not maintain any separate bank accounts/central severance pay funds intended solely to cover any liabilities arising from employee's severance pay.

1.5.2.1.4 The amount payable is one monthly salary for each year's employment, based on the final salary prior to termination of employment, and depending on the personal agreement, usually net of the accrual balance in the severance pay fund.

1.5.2.1.5 For some employees, the company has signed an agreement under paragraph 14 of the severance pay law[26], whereby the company makes regular deposits of 8.33% of salary into a recognised severance pay fund. The accrued balance in this fund covers any future severance pay obligation, and the company does not need to supplement this amount. There is thus no further liability for these employees once the agreement is signed. The company maintains a liability only on that period of service up to the time of signing the agreement, which is reflected in the calculations below. This liability is calculated at the time of severance as period of time until paragraph 14 agreement is signed multiplied by the final salary at the time of leave.

1.5.2.1.6 Under Israeli law severance pay is paid only to employees with over one year of service with the company. Nevertheless, employees with less than one year's service are included in the valuation, as their first year of service forms a constructive obligation towards future payments, as required by IAS 19.69.

1.5.2.1.7 The liability for employee severance pay calculated here represents the unfunded balance of the total liability.

1.5.3 Calculation method

1.5.3.1 As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

1.5.3.2 The defined benefit obligation reflects the entitlement earned by active employees only.

1.5.3.3 As per IAS 19.102-4 the individual asset values have been calculated using a discounted cashflow approach.[27] The individual assets are assumed to be credited with interest earnings, albeit some policies in the past have not been credited with such earnings, as such earnings were allocated entirely to non-severance pay related portion of the insurance policy. If this is the case an the company is not able to change the methodology opposite the insurer, then the valuation has to be altered to reflect a –0.5% real return on the account value[28].

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[25] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[26] Severance Pay Law, 5723-1963

[27] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

[28] The negative return is necessary to reflect the fact that the severance part of the policy is credited with the lower of the actual performance and inflation index. There is no carry forward provision for years with negative real return, such that the account effectively is expected to earn on average less than inflation.

2. Data basis

2.1 Bezeq

The calculations are based on the data supplied to us by Bezeq as of the valuation date. We have relied upon these data, which have been prepared by the responsible employees of the company. We have not checked these data, although the company has confirmed that the data supplied to us are accurate. We have reviewed all key data for reasonableness.

In particular, we have relied upon Bezeq to supply us with the full population that is relevant for each benefit.

The following tables summarise the data on which the valuation was based:

2.1.1 Severance pay (no §14 exemption):

	31/12/2004	31/12/2005	31/12/06
Number of employees	1,049	1,077	1,112
Total Salary	8,046,009	9,846,932	10,916,910
Total Service	5,625	6,641	7,608
Total Liability	56,030,080	69,888,755	83,153,355
Total Assets	54,127,113	63,146,151	70,160,462

2.1.2 Severance pay (with § 14 exemption)

	31/12/2004	31/12/2005	31/12/06
Number of employees	1,389	1,594	2,243
Total Salary	4,889,376	5,866,901	8,383,023
Total Service	883	1,217	1,639
Total Liability	3,170,848	4,490,372	6,392,019

2.1.3 Sickness:

	31/12/2004	31/12/2005	31/12/06
Number of employees	8,505	8,114	7,928
Total gross sickness days accrued	2,601,289	2,635,504	2,749,658
Total gross sickness days used/redeemed	1,016,967	1,075,866	1,120,910
Net sickness days accrual	1,584,322	1,559,638	1,628,748
Average redemption value for sickness day	245	253	286
Average usage value for sickness day	313	322	365

2.1.4 Vacation:

	31/12/2004	31/12/2005	31/12/06
Number of employees	8,505	8,114	7,928
Total gross vacation days accrued	1,857,165	1,882,064	1,975,001
Total gross vacation days used/redeemed	1,690,847	1,722,109	1,812,976
Net vacation days accrual	166,318	159,955	162,025
Average redemption value for vacation day	274	283	298
Average usage value for vacation day	350	360	380

2.1.5 Retirees:

Population	12/2004	12/2005	12/2006
Active	4,588	4,434	4,375
Retiree	5,417	5,571	5,630
Spouses	869	869	869

The information on survivors was not available for the 2004 valuation. In general, a more thorough database is expected to be provided for future valuations, once it is clear what data is required to create the IAS 19 reports. For the periods, for which it was clear that number of survivors receiving the benefits were known, the birthdays of the spouses benefiting were not known. In such instances, we have used the statistical age table provided by of the pension circular 2000/1 of the Ministry of Finance.

2.2 Bezeq Senior

2.2.1 The calculations are based on the data supplied to us by Bezeq as of the valuation date. We have relied upon these data, which have been prepared by the responsible employees of the company. We have not checked these data, although the company has confirmed that the data supplied to us are accurate. We have reviewed all key data for reasonableness.

2.2.2 In particular, we have relied upon Bezeq to supply us with the full population that is relevant for each benefit.

2.2.3 With regard to the savings balances for 31/12/2006, we have estimated them based on opening balances and deposits made as recorded by the company.

2.3 Pelephone

2.3.1 The calculations are based on the data supplied to us by Pelephone as of the requested valuation dates. In addition some data has been provided for dates preceding the first valuation date, such that the underlying statistical analysis uses some information, which is independent of the valuation dates at hand.

2.3.2 I have relied upon these data, which have been prepared by the responsible employees of the company. I have not checked these data, although the company has confirmed that the data supplied to me are accurate. I have reviewed all key data for reasonableness.

2.3.3 With regard to senior employees, we have received a single liability figure and no actuarial calculations were performed as per the understanding of management and accountants the impact would be negligible on the entire balance sheet. The provided total liability is included in this report.

2.3.4 Vacation day cost was provided without including social benefit costs of a 32%, which were added externally to the report. This augmentation was applied to the vacation day benefits of employees, as well as the information provided for senior employees separately (see 4) c).

2.3.5 With regard to the early notice benefit for non-senior employees, we have been provided with partial benefits paid information, as the company needs to revise the way this benefit given to employees who leave is kept track off. As such, current actuarial apparent gains in this area of reporting, is not reflective of the actual situation, which over time will become more accurate.

2.4 Bezeq International

The calculations are based on the data supplied to us by Bezeq International as of the requested valuation dates. In addition some data has been provided for dates preceding the first valuation date, such that the underlying statistical analysis uses some information, which is independent of the valuation dates at hand.

I have relied upon data prepared by the responsible employees of Bezeq International. These data have not been checked by me, although the Bezeq International has confirmed that the data supplied to me are accurate. I have reviewed all key data for reasonableness

2.4.1 Historical Information

2.4.1.1 Salary Information: for all 1,440 employees as of end of 2006 has been provided for each year since 2002. However, employees who have left in the interim period, no salaries were provided.

2.4.1.2 Leave information: information was only provided for calendar years 2002 and 2006.

2.4.2 In force Population

2.4.2.1 The company employed at the end of 2005 1,089 employees. During 2006 371 additional employees left the company while 722 employees joined resulting again in 1,440 employees present at the end of 2006. In 2006 valuation there are 824 men and 616 women. The average age for males is 28.74, while the female population is younger during 2006 with average age of 27.84.

2.4.3 Severance Pay

2.4.3.1 The total salaries included in 2005 were 7,174,796 million, whereas at the end of 2006 the salaries summed to 8,841,634 million NIS.

2.4.3.2 The total employment years were 2,378.22 as of the end of 2005, which increased to 2,874.27 years after the exchange of employees and additional employment years' accruals.

2.4.3.3 The total gross liability for 2005 provided is 19.5 million NIS and 24.3 million NIS as of 31/12/2006.

2.4.3.4 Individual insurance assets totalled 13.0 million NIS, where during the course of 4.9 million NIS were deposited and the ending balance amounted 15.4 million NIS.

2.4.3.5 Parallel to comment 4d) ii), probably information for employees who left is missing. In addition there are policies, which seem to be lacking deposit/premium information.

2.4.4 Vacation Days

2.4.4.1 During 2006 (ca. 3,420.77 working years) only 244 employees used up a total of 1,049 accrued vacation days, while all the other employees increased their accrued balances.

2.4.4.2 Liability for vacation usage is 3,066,455 NIS at end of 2005 and 4,045,236 NIS at end of 2006.

2.5 YES

The calculations are based on the data supplied to us by DBS Ltd. as of the requested valuation dates. In addition some data has been provided for dates preceding the first valuation date, such that the underlying statistical analysis uses some information, which is independent of the valuation dates at hand.

I have relied upon these data, which have been prepared by the responsible employees of the company. I have not checked these data, although the company has confirmed that the data supplied to me are accurate. I have reviewed all key data for reasonableness.

The data did not include any information on senior employees of the company, who are consequently not included in this report.

2.5.1 Historical Information

2.5.1.1 Salary Information: the company provided salary information for the end of each year from 2002 for employees who were still employed at the end of 2006.

2.5.1.2 Leave information: the company provided information on leaves for each year from 2001.

2.5.1.3 Sickness history: the company provided information on the accrual and usage of sickness days from 2001.

2.5.1.4 Vacation history: the company provided information on the accrual and usage of vacation days from 2004.

2.5.2 Severance Pay

2.5.2.1 For employees without exemption under paragraph 14 (see 1.5.2.1.5), the company provided information on the balances in the savings accounts only for the end of May 2006 and October 2006. The company also provided information on the nominal deposits to these accounts for each month of 2005 and 2006.[29] Based upon this information, we have estimated the savings balance accrual at each valuation date, assuming a 3% return on assets, and assuming that deposits were made in the middle of each inter-valuation period. The actual savings accruals at each valuation date may be significantly different from these estimates.

2.5.2.2 We were provided with the following information relating to severance pay obligations, for employees with exemption under paragraph 14 (the figures presented here do not include employees with less than one year of service):

	Number of Employees	Total Service	Total Salaries	Total Period of Obligation*	Average Service	Average Salary	Average Period of Obligation*	Gross Nominal Liability
31/12/2004	798	2,240	4,973,580	535	2.81	6,233	0.67	2,535,307
31/12/2005	827	2,516	4,964,007	551	3.04	6,002	0.67	2,479,206
31/03/2006	778	2,459	4,794,666	524	3.16	6,163	0.67	2,356,846
30/06/2006	764	2,491	4,877,342	485	3.26	6,384	0.63	2,189,818
30/09/2006	742	2,525	4,730,999	464	3.40	6,376	0.63	2,067,993
31/12/2006	751	2,587	4,800,654	501	3.44	6,392	0.67	2,216,457

2.5.2.3 We were provided with the following information relating to severance pay obligations, for employees without exemption under paragraph 14:

	Number of Employees	Total Service	Total Salaries	Total Savings Accrual*	Total Savings Deposit	Average Service	Average Salary	Gross Nominal Liability
31/12/2004	289	792	1,687,168	3,799,358		2.74	5,838	4,946,298
31/12/2005	403	1,233	2,351,245	5,373,866	1,310,555	3.06	5,834	7,736,556
31/03/2006	421	1,347	2,484,276	5,792,717	377,214	3.20	5,901	8,596,239
30/06/2006	447	1,477	2,645,968	6,255,206	401,994	3.30	5,919	9,438,172
30/09/2006	432	1,513	2,535,061	5,682,229	397,572	3.50	5,868	9,565,039
31/12/2006	400	1,487	2,457,422	5,633,731	388,240	3.72	6,144	9,705,403

* Estimated accrual – see above.

[29] The contributions provided were for the entire employer element of the contribution (both for retirement (Tagmulim) and severance pay (Pitzuim). We have assumed contributions of 5% of salary for the former and 8.33% of salary for the latter, and have used only the estimated severance part of the contributions.

2.5.3 Vacation Days

2.5.3.1 We were provided with the following information regarding vacation days accrual:

	Number of Employees	Total Net Accrued Vacation Days	Total Vacation Day Value	Average Accrued Vacation Days	Average Vacation Day Value	Gross Nominal Liability	Liability for Management	Total Gross Nominal Liability
31/12/2004	1,792	15,663	529,608	8.74	296	6,238,917	1,265,284	7,504,201
31/12/2005	1,714	15,720	545,437	9.17	318	6,520,882	1,328,548	7,849,430
31/03/2006	1,684	16,571	543,419	9.84	323	7,104,034	1,655,491	8,759,525
30/06/2006	1,701	16,561	554,460	9.74	326	7,115,451	1,611,809	8,727,260
30/09/2006	1,708	16,660	558,014	9.75	327	7,172,533	1,666,525	8,839,058
31/12/2006	1,654	16,251	557,343	9.83	337	7,232,690	1,730,105	8,962,795

2.5.4 Sick Days

We were provided with the following information regarding sick day accrual:

3. Actuarial assumptions

3.1 Bezeq

The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:

Mortality rates are based on the recently published Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts.[30]

3.1.1 Disability rates are based upon table 2.A of the aforementioned document.

3.1.2 The leave rates assumed, based on the experience of the company over the last five years, and which assumes that all leaves are compensated with full severance pay, is split into three categories of employees: permanent/tenured ones which have Dirug 90 or not, and temporary employees (Office code 796):

Years of	Permanent/Tenured		Temporary
Employment	Dirug 90	Non-Dirug 90	Office Code 796
1	5.50%	3.50%	34.18%
2	5.50%	3.00%	35.75%
3	5.50%	2.64%	26.83%
4	5.50%	2.29%	21.14%
5	5.50%	1.93%	21.29%
6	5.50%	1.57%	30.67%
7	5.50%	1.21%	25.00%
8	5.50%	0.86%	25.00%
9	5.50%	0.50%	25.00%
10+	5.50%	0.50%	25.00%

[30] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf. In the mean time a new basis is being developed for pension fund valuations, as well, which is currently only in the form of a draft. Once such basis is finalized, it is likely that the basis, which was included in this valuation, will be replaced with the pension fund oriented mortality basis.

3.1.3 Early retirement expectations: based on the following percents for each valuation period (consistent with the early retirement actuarial report provided to Bezeq each quarter.)

Duration	31/12/04	31/12/05	1/06-9/06	31/12/06		
				Early Retirement		
				Transferred	Non-Transferred	Leave For Severance
Early Retirement Agreement 2003						
1	20.7%	60.8%	50.0%	11%	11%	0.0%
2	27.1%	13.4%	11.0%	0.0%	0.0%	0.0%
3	10.6%	10.3%	0.0%	0.0%	0.0%	0.0%
4	10.0%	0.0%	0.0%	0.0%	0.0%	0.0%
5	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Early Retirement Agreement 2006						
1				81.9%	31.7%	6.41%
2				45.0%	7.2%	2.98%
3				0.0%	0.0%	0.0%
4				0.0%	0.0%	0.0%
5				0.0%	0.0%	0.0%

3.1.4 Accrued Sick days:

Utilization: Based on the company's experience (over the limited period submitted), the annual accrual of sick days (which is not capped) is more than sufficient to cover ongoing needs for sick day leaves. As such the accrued balance of sick days generally is not expected to be put to use to cover such future expenses and no IAS 19 liability exists. Occasionally there are a few cases, which use accrued sick days due to an extended sickness period. However, they are quite limited. In addition, since IAS 19 requires the methodology of LIFO in accounting for the use of accrued benefits, the sick days to be used in a future projection in excess of the then annual accrual, would mostly be using future sick day accruals. Only for the next few years may part of the accrued sick day balance maybe used for such sickness incidences. I consider these incidences of immaterial size and have excluded them from this valuation.[31] As the population ages, this assumption maybe reviewed and the report modified based on evolving experience.

3.1.4.1 Redemption Value: We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1.1.1.2.3, and expected usage rates as follows: for permanent employees – for females, 18 days per year; for males, 8.3 days per year at age 24 and below, falling linearly to 2.3 days per year from age 36. For temporary employees we have assumed 9 days usage per year. [32] The future projection assumes a "last in first out" methodology.

3.1.5 Accrued vacation days:

3.1.5.1 Utilization – for permanent employees, it is assumed that in each year there is accrual of additional vacation days. When the limit on the number of accrued days is reached, we have assumed that no further days are added to the existing accrual[33]. For temporary employees, in the early years of service, it is possible that there can be utilization of existing vacation days. These utilizations are included in the valuation figure.

[31] With the exception of cases of disability, which are assumed to use the maximum allowable number of days: either the net accrued days, or 90 days, whichever is lower.

[32] These assumptions mean that the current accrual will be carried forward to redemption, except in the case of disability, where there is a slow reduction in the usage of the current days, as noted in footnote 3.

[33] In accordance with the "last in first out" methodology prescribed by IAS 19.

3.1.5.2 Redemption value - We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1.1.1.1.1, and an expected usage of 20 vacation days per year in the future, for both males and females, for permanent employees and 12 vacation days per year in the future, for both males and females, for temporary employees. These figures are borne out by statistical analysis of the current data, in which no clear dependency of level of utilization and age could be detected thus far. The future projection assumes a "last in first out" methodology.

3.1.5.3 In view of the limited number of years experience currently available, these assumptions were felt to be reasonable. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

3.1.5.4 The calculations are based on the following financial assumptions:

3.1.5.5 The discount rate used is based on the yield of fixed-interest Israeli government bonds[34] with duration equal to the duration of the gross liabilities:

	Valuation	Duration of Liability (Years)			Discount Rate		
	Date	Dec-04	Dec-05	Dec-06	Dec-04	Dec-05	Dec-06
A.1	Severance	11.83	11.70	11.47	4.161%	3.754%	3.600%
A.2	Severance – 1st Year	8.14	7.05	4.08	3.929%	3.605%	3.675%
B	Sick Days	18.49	18.71	17.25	4.383%	3.894%	3.602%
C	Vacation Days	14.70	14.49	11.27	4.257%	3.810%	3.611%
D.1	Holiday Gift[35]	14.11	13.92	13.84	5.630%	5.200%	5.200%
D.2	Clubs	15.00	14.00	13.50	4.270%	3.800%	3.600%
D.3	Activities	14.11	13.92	13.84	4.237%	3.798%	3.604%

3.1.6 <u>Salary increase assumptions:</u>

3.1.6.1 For permanent employees, we assumed, based on the company's experience: 6% per annum at age 20 falling linearly to 1.75% per annum at age 60.

3.1.6.2 For temporary employees, we have assumed 0.45% per annum at all ages.[36]

3.1.7 Holiday Bonus: The bonus is set at $100 per annum, where we used the following foreign exchange rates and VAT assumptions. The bonus amount does not include any social costs or taxes.

	12/2004	12/2005	12/2006
$/NIS	4.308	4.603	4.200
VAT	17.0%	16.5%	15.5%

No real increase is assumed. For active employees the benefit is recorded based on the accrued service period relative to expected total service period, where the total expected service period includes expectations of early retirement for the pool of qualifying employees[37]

[34] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used amount yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

[35] The holiday gift benefit is based on a US dollar benefit amount, and as such the IAS 19 prescription with regard to the discount rate in §78 "The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations." The benefit is not adjusted for local inflation experience. Hence, the yields used for this benefit are nominal US high-quality (AAA) corporate yields for a 15 year duration.

[36] As we assume high leave rates for these employees, based on the company's experience, the impact of the low salary increase assumption is small.

[37] The fractional recognition of the liability in respect of accrued service period is applied across the board to all benefit elements: retire, disabled, active survivor, retired survivor. One could argue that in respect of active survivor and disabled benefits, the benefit has already fully accrued and as such IAS 19 would require a full recognition of such benefits. This point is under clarification. In any event, the impact is expected to be negligible, as the fully vested retirees and the retirement benefit of actives carry the lion's share of the liability.

3.1.8 Clubs: Based on the assumption of 1.85 million NIS annual expense on behalf of Bezeq, which is allocated between current retirees based on 100% accrual and future expected retirees based on their accrued seniority fraction. For example, for an employee who is expected to retire at age 63 after 30 years of service and he has currently 20 years of service, a factor of 2/3 is applied towards is expected chance of benefiting from this benefit in the future.

3.1.9 Activities: An assumed per family expense of 300 NIS for the valuation periods 12/2004 and 12/2005 and an increased expense of 332 for 12/2006. No real increase is assumed.

3.1.10 The rate of growth of the accrued balance in individual savings plans is assumed to be 2.0% p.a. This reflects the fact that the majority of the savings balances are in old pension funds, where there is a fixed formula for the redemption value of the funds. This approach is slightly conservative, as some of the funds are invested in participation policies in insurance funds and some in new pension funds, and we would expect the long-term net real returns on these funds to be higher.

3.2 Bezeq Senior

The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:

3.2.1 Mortality rates are based on the recently published Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts.[38]

3.2.2 Disability rates are based upon table 2. .אof the aforementioned document.

3.2.3 The leave rates assumed, based on management's assessment of future expected leaves, are 20% per annum.

3.2.4 **Accrued Sick days:**

3.2.4.1 Utilization: Based on the company's experience (over the limited period submitted), the annual accrual of sick days (which is not capped) is more than sufficient to cover ongoing needs for sick day leaves. As such the accrued balance of sick days generally is not expected to be put to use to cover such future expenses and no IAS 19 liability exists. Occasionally there are a few cases, which use accrued sick days due to an extended sickness period. However, they are quite limited. In addition, since IAS 19 requires the methodology of LIFO in accounting for the use of accrued benefits, the sick days to be used in a future projection in excess of the then annual accrual, would mostly be using future sick day accruals. Only for the next few years may part of the accrued sick day balance maybe used for such sickness incidences. I consider these incidences of immaterial size and have excluded them from this valuation.[39] As the population ages, this assumption maybe reviewed and the report modified based on evolving experience.

3.2.4.2 Redemption Value: We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1.1.1.2.3, and expected usage rates as follows: for permanent employees – for females, 18 days per year; for males, 8.3 days per year at age 24 and below, falling linearly to 2.3 days per year from age 36.[40] The future projection assumes a "last in first out" methodology.

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[38] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf

[39] With the exception of cases of disability, which are assumed to use the maximum allowable number of days: either the net accrued days, or 90 days, whichever is lower.

[40] These assumptions mean that the current accrual will be carried forward to redemption, except in the case of disability, where there is a slow reduction in the usage of the current days, as noted in footnote 3.

3.2.5 **Accrued vacation days:**

3.2.5.1 Utilization – it is assumed that in each year there is accrual of additional vacation days. When the limit on the number of accrued days is reached, we have assumed that no further days are added to the existing accrual[41].

3.2.5.2 Redemption value - We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1.1.1.1.1, and an expected usage of 20 vacation days per year in the future, for all employees. These figures are borne out by statistical analysis of the current data, in which no clear dependency of level of utilization and age could be detected thus far. The future projection assumes a "last in first out" methodology.

3.2.6 In view of the limited number of years experience currently available, these assumptions were felt to be reasonable. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

3.2.6.1 The calculations are based on the following financial assumptions:

i) The discount rate used is based on the yield of fixed-interest Israeli government bonds[42] with duration equal to the duration of the gross liabilities:

	Duration			**Interest Rate**		
	31/12/2004	**31/12/2005**	**31/12/2006**	**31/12/2004**	**31/12/2005**	**31/12/2006**
	4.30	4.27	4.20	3.36%	3.50%	3.67%
Vacation	4.44	4.42	4.32	3.39%	3.50%	3.67%
Sickness	4.91	4.61	4.30	3.48%	3.50%	3.67%
Early Notice	4.60	4.52	4.59			3.66%

3.2.7 Salary increase assumptions – based upon management's assessment of future expected salary increases for senior employees, we have assumed a rate of 6% per annum.

3.2.7.1 The rate of growth of the accrued balance in individual savings plans is assumed to be 2.0% p.a. This reflects the fact that the majority of the savings balances are in old pension funds, where there is a fixed formula for the redemption value of the funds. This approach is slightly conservative, as some of the funds are invested in participation policies in insurance funds and some in new pension funds, and we would expect the long-term net real returns on these funds to be higher.

3.3 Pelephone

The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:

3.3.1 Mortality rates are based on upon the rates specified in the insurance circular 2007-1-3 issued by the Israeli Ministry of Finance, including future mortality improvements.

3.3.2 Disability rates are based upon table 2. .אof the pension circular 2000/1 of the Ministry of Finance.

3.3.3 The leaves assumed differentiating between with entitlement to full severance pay ("With" column) and without severance pay, based on the experience of the company, is as follows:

[41] In accordance with the "last in first out" methodology prescribed by IAS 19.

[42] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used amount yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

	Senior		Non-senior	
Year	**With**	**Without**	**With**	**Without**
1	8.0%	12.0%	5.0%	45.0%
2	8.0%	11.0%	25.0%	17.0%
3	8.0%	10.0%	25.0%	7.0%
4	8.0%	9.0%	25.0%	7.0%
5	8.0%	8.0%	25.0%	7.0%
6	8.0%	7.0%	25.0%	7.0%
7	8.0%	6.0%	25.0%	7.0%
8	8.0%	5.0%	25.0%	7.0%
9	8.0%	4.0%	25.0%	7.0%
10	8.0%	3.0%	25.0%	7.0%
11+	8.0%	2.5%	25.0%	7.0%

3.3.4 Accrued Sick days:

3.3.4.1 Utilization: Given the young age of the population and the big turn-over, there is no noticeable accrued liability for sick days and generally sick days will be used from future accrued sick days.

3.3.4.2 Redemption: no redemption benefit for sick days exists at Pelephone.

3.3.5 Accrued Vacation days:

3.3.5.1 The future annual usage of vacation days according to age, and based on the company's experience, is as follows:

Age	Usage	Age	Usage
21	5.65	**31**	12.15
22	6.30	**32**	12.80
23	6.95	**33**	13.45
24	7.60	**34**	14.10
25	8.25	**35**	14.75
26	8.90	**36**	15.40
27	9.55	**37**	16.05
28	10.20	**38**	16.70
29	10.85	**39**	17.35
30	11.50	**40+**	18.00

3.3.5.2 In view of the limited number of years experience currently available, these assumptions were felt to be reasonable. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

3.3.5.3 The calculations are based on the following financial assumptions:

3.3.5.4 The discount rate used is based on the yield of fixed-interest Israeli government bonds[43] with duration equal to the duration of the gross liabilities:

[43] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used amount yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

	Duration of Liability (Years)			Discount Rate		
Valuation Date	Severance	Early Notice	Vacation Days	Severance	Early Notice	Vacation Days
12/2004	4.78		3.84	3.46%		3.28%
12/2005	4.88		3.74	3.50%		3.50%
3/2005	4.89		3.77	3.70%		3.70%
6/2005	4.89		3.79	3.90%		3.92%
9/2006	4.95	7.72	3.82	3.90%	3.97%	3.90%
12/2006	4.59	7.68	3.75	3.66%	3.63%	3.50%

3.3.6 Salary increase assumptions:

3.3.6.1 Based on recent experience of the company, we arrived at the following salary development for senior employees (department and division managers): At age 21, use 4% salary increase, which increases linearly to 14% at age 28. Until age 39 the salary increase declines to 2.5% and remains there until retirement.

3.3.6.2 Non-senior employees: age 21 to 28 use 16% salary increase. Until age 39 the salary increase declines to 2.5% and remains there until retirement.

3.3.6.3 The rate of growth of the accrued balance in individual savings plans, which were issued before 1/1/1990 is assumed to be 4.25% p.a., which reflects the insurance plan of noticeable seniority. For policies issued after 31/12/1989, I assumed 3.0% (4.0% earnings rate minus 1.0% management fee). For a small interim period of 2 years this is a slightly conservative assumption, as there was still some partial Government subsidy to the savings account. However, the simplification, in my opinion, does not create a material deviation. As per management's confirmation, the severance component of the savings plan indeed receives interest earnings. This treatment differs from the default approach insurance companies have taken in the past, where the interest earned on severance policies was generally allocated to the Tagmulim portion of the account.

3.3.6.4 The rate of growth of the separate plan assets is assumed to be 3.0% p.a. This reflects 4.0% expected market return after the deduction of 1.0% management fees.

3.3.6.5 Early notice benefit: the company has not kept track in a clear way as to when the benefit is utilized and when the company continued paying the regular salary, as the person elected to work until the last day before his leave. For this valuation management has proposed that one month's pay be assumed for department managers and three months' salary for the division managers and six months' pay for vice presidents.

3.4 Bezeq International

The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:

3.4.1 Mortality rates are based on the recently published Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts.[44]

[44] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf. In the mean time a new basis is being developed for pension fund valuations, as well, which is currently only in the form of a draft. Once such basis is finalized, it is likely that the basis, which was included in this valuation, will be replaced with the pension fund oriented mortality basis. In any event mortality assumptions have a relatively negligible impact on the valuation.

3.4.2 Disability rates are based upon table 2.A of the aforementioned document.

	Staff		Temporary	
Year	With	Without	With	Without
1	2.2%	17.6%	3.3%	48.1%
2	9.2%	9.8%	13.9%	11.5%
3	11.7%	9.3%	19.0%	7.5%
4	12.3%	6.4%	26.3%	7.3%
5	11.4%	6.2%	24.7%	6.8%
6	11.0%	4.8%	16.4%	3.0%
7	10.9%	2.0%	9.6%	3.0%
8	10.0%	2.0%	9.8%	3.0%
9	8.0%	2.0%	8.0%	3.0%
10	6.0%	2.0%	6.0%	3.0%
11+	4.0%	2.0%	4.0%	3.0%

3.4.3 The leave assumed differentiating between with entitlement to full severance pay ("With" column) and without severance pay, based on the experience of the company, is as follows. A leave without severance pay means that to the employee receives his accrued savings balance only irrespective of whether the severance pay liability is higher or lower than the savings balance. In addition we were informed and observed accordingly that the company employs two distinct populations: a core staff of ca. 150 employees and the rest are temporary workers who have a far higher turn-over and a lower salary.

3.4.4 **Vacation Days:** The model assumes that employees on average utilize 2 days of accrued vacation (2006 observation).

3.4.4.1 In view of the limited size of the company and the limited number of years experience currently available, these assumptions were felt to be reasonable, although the credibility of these assumptions is quite limited. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

3.4.4.2 The calculations are based on the following financial assumptions:

3.4.4.2.1 The discount rate used is based on the yield of fixed-interest Israeli government bonds[45] with duration equal to the duration of the gross liabilities[46]:

	December 31st 2004		December 31st 2005		December 31st 2006	
	Duration	Interest	Duration	Interest	Duration	Interest
Severance	7.84	3.88%	8.21	3.70%	8.29	3.62%
Vacation	3.36	3.24%	3.93	3.50%	5.19	3.65%

45 Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used Government Bond yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

46 Whilst the final valuation date is 31st December 2006, the valuation was performed prior to that date, by estimating the expected situation at that time. As such, the actual discount rates were unknown at the time of the valuation. We have used the valuation rates for 30th November 2006 as the closest available alternative.

3.4.5 Salary increase assumptions:

3.4.5.1 For staff the salary increase is assumed to be 7.0% until age 34, at which point the salary increase decreases each year by 1.0% until it stabilizes at age 40 at 1.0% real salary increase.

3.4.5.2 For temporary employees, we assumed a flat 1.0% real salary increase for all ages. As the “life” of the severance liability for these type of employees is fairly short, the actual salary increase assumption is less significant.

3.4.5.3 The rate of growth of the accrued balance in individual savings plans is assumed to be 3.0% p.a. This reflects 4.0% expected market return after the deduction of 1.0% management fees. (See also 3 c).)

3.5 YES

The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:

3.5.1 Mortality rates are based on upon the rates specified in the insurance circular 2007-1-3 issued by the Israeli Ministry of Finance, including future mortality improvements.

3.5.2 Disability rates are based upon table 2. .אof the pension circular 2000/1 of the Ministry of Finance.

3.5.2.1 Based on the company leave rate experience as provided to us, we have assumed leave rates dependent on length of service differentiating between with entitlement to full severance pay (“With” column) and without severance pay, as follows. A leave without severance pay means that to the employee receives his accrued savings balance only irrespective of whether the severance pay liability is higher or lower than the savings balance.

Year of Service	With	Without
0	20.66%	27.00%
1	12.42%	10.34%
2	9.10%	6.27%
3	6.15%	6.05%
4	4.97%	4.24%
5+	2.00%	2.00%

3.5.3 Vacation day utilization - based upon the company experience, we expect that future accruals will be positive, ie the employee will use the current accrued days only in the event of leaving the company’s employ.

3.5.4 Sick Days – based on the experience provided by the company, we expect employees to use an average of 2.3 sick days per year. For the long term sickness, which is usually associated with a disability, we assumed the following:

3.5.4.1 90 day disability: based on disability rates as outlined in 5) a) ii)

3.5.4.2 60 day disability: 20% of the 90 day cases

3.5.4.3 30 day disability: 20% of the 90 day cases

3.5.4.4 Assumptions (a) and (b) need to be observed as more data becomes available. These assumptions translate into an average disability length of 77 days, at a 140% level of the published 90-day waiting period disability table.

3.5.5 Retirement Age: as per the new pension law[47], based on the employee's date of birth and gender, the retirement age increases from 65 to 67 for men and from 60 to 64 for women.

3.5.5.1 In view of the limited number of years experience currently available, these assumptions were felt to be reasonable, although the credibility of these assumptions is quite limited. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

3.5.5.2 The calculations are based on the following financial assumptions:

3.5.5.3 The discount rate used is based on the yield of fixed-interest Israeli government bonds[48] with duration equal to the duration of the gross liabilities:

	Severance Pay		Vacation	
Valuation Date	**Duration**	**Discount Rate**	**Duration**	**Discount Rate**
31/12/2004	17.38	4.346%	16.43	4.314%
31/12/2005	18.71	3.894%	16.88	3.858%
31/03/2006	18.80	3.900%	16.45	3.900%
30/06/2006	18.88	3.907%	16.31	3.900%
30/09/2006	18.84	4.000%	16.26	3.942%
31/12/2006	19.42	3.605%	16.19	3.602%

3.5.6 **Salary increase assumptions: 5% per annum for all employees.**

3.5.6.1 The rate of growth of the accrued balance in individual savings plans is assumed to be 3.0% p.a. This reflects 4.0% expected market return after the deduction of 1.0% management fees. See, however, 1.5.3.3 and footnote 28.

[47] Retirement Age Law, 5764-2004

[48] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used Government Bond yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

4. Results **(All companies, without Corridor, Amounts are in '000 NIS)**

		Net Defined Benefit Obligation			Benefit Expense	
		31/12/2004	**31/12/2005**	**31/12/2006**	**2005**	**2006**
Long Term Benefits						
A.1	Vacation Days	80,387.4	83,855.4	90,472.8	23,333.8	31,464.5
A.2	Sick Days	53,032.0	55,955.1	65,429.0	16,421.3	13,618.3
Termination Benefits						
B	Early Retirement Total	820,100.0	536,000.0	726,243.1	(120,131.0)	196,959.0
Post Employment Benefits						
C.1	Severance	54,335.4	61,649.3	68,160.1	27,147.3	33,689.2
C.2	Early Notice	0.0	0.0	31,799.4	0.0	31,826.4
C.3	Holiday Gift	51,693.6	58,259.4	51,954.4	9,803.7	(2,785.1)
C.4	Clubs	35,153.6	38,516.2	39,242.5	5,212.6	2,576.3
C.5	Activities	35,446.0	38,985.8	43,455.8	5,467.0	6,439.2
	Total	1,130,147.9	873,221.2	1,116,757.0	(32,745.3)	313,787.7

I hereby provide permission to publish this actuarial opinion.

David Engelmayer, M.S., M.A.A.A., F.S.A., F.II.A.A.
Actuary

Prof. Aranya & Co.

Financial Consultants Ltd.

8 Shaul Hamelech Blvd.
Tel Aviv 64733
Tel: 03-6938322
Fax: 03-6938323

Tel Aviv, March 28, 2007

Bezeq the Israel Telecommunication Corporation Ltd
Azriely Center, the Triangle Building
Tel Aviv

Re: Valuation – Employee Options that were granted by the Company

Dear Sir,

We were asked by Bezeq the Israel Telecommunication Corporation Ltd (hereinafter: **"the Company"** and/or **"Bezeq"**) to express our professional opinion with regard to the fair value of the options for Company shares, which were granted to the employees of the Company by the State of Israel at the end of December 2005, in order to record the value of the benefit as an expense in Bezeq's books.

The opinion examines the fair economic value of the options in accordance with the requirements of Accounting Standard 24 and International Accounting Standard 2 (IFRS 2).

In order to prepare our opinion we relied on data that we received from the Company and we assumed that the said data was correct, accurate and complete. In order to prepare our opinion we perused the following documents, *inter alia*:

- An outline of the Company's securities offering to the employees of the Bezeq Group dated September 15, 2005
- Details about the negotiability of Bezeq's share at the Tel Aviv Stock Exchange
- Details about the yield on State of Israel Bonds
- Any other document and datum which, in our opinion, was required for the purposes of this opinion.

The information that we received from the Company appeared to us to be reliable. However, we did not independently examine and/or verify the data that we were given, apart from general reasonability tests, and the responsibility for them applies to the Company alone. Prof. Aranya & Co. is not responsible for the data, the integrity thereof and the accuracy thereof.

In order to prepare the opinion we met/spoke with representatives of the Company from the areas of finance, budget and financing, and we obtained comments from the Company's legal advisors.

We hereby confirm that we have no personal interest in Bezeq, and that we have no personal interest in the deal that is described. No dependence or connection as defined in Section 240 (B) of the Companies Law, 5759 – 1999 exists between us and the Company and interested parties in the Company, and our fee is not contingent on the results of the opinion.

In connection with the opinion, Bezeq undertook as follows vis-à-vis Prof. Aranya & Co Financial Consultants Ltd: Should Prof. Aranya & Co Financial Consultants Ltd and/or any of the managers thereof and/or the employees thereof (hereinafter: **"Aranya & Co"**) be ordered in the framework of legal proceedings to pay any sum whatsoever to a third party, including to shareholders, in connection with the opinion of fairness that was prepared by Aranya & Co with regard to the value of the options for shares of Bezeq the Israel Telecommunication Corporation Ltd (hereinafter: **"Bezeq"**) that were granted to the Company employees by the State of Israel (hereinafter: **"the Opinion"**), and the services that were provided with regard thereto, Bezeq will indemnify Aranya & Co in respect of any sum that it is ordered to pay as stated, and in respect of reasonable expenses (taking into account the scope of the proceedings and the attorneys and advisors who are appointed to handle the matter) that Aranya & Co expends or is required to expend for legal representation, legal advice, defense from legal proceedings, negotiations and the like, in connection with any claim, demand or other proceedings whose cause stems from or is in any way related to the aforementioned Opinion, and to which the obligation of indemnification as per this statement applies. The

obligation of indemnification will not apply if it is determined that Aranya & Co acted negligently or maliciously in connection with the Opinion or the services that were provided in connection therewith.

We hereby agree that this Opinion will be included and/or referenced in Bezeq's financial statements and/or in any other report that Bezeq is required to submit under any law. Additionally, Bezeq will be entitled to make use of the Opinion before any person, body and authority, as it shall see fit.

Sincerely yours,

Nissim Aranya[1] Benny Hoch[1]

Prof. Aranya & Co – Financial Consultants Ltd

[1] Following are the details of our education:

Prof. Nissim Aranya holds an undergraduate degree in Economics from Hebrew University and an MBA from New York University. He earned his doctorate at the London School of Economics and is a Certified Public Accountant in Israel.

Benny Hoch holds an undergraduate degree in Economics and Accounting, an MBA and an LLM, all from Bar Ilan University. He graduated from the real estate appraisal program at Tel Aviv University and is a Certified Public Accountant in Israel.

Valuation of the Bezeq Options

Background

Following the privatization of Bezeq the Israel Telecommunication Corporation Ltd (hereinafter: **"the Company"** and/or **"Bezeq"** as defined above), it was agreed between the Government Companies Authority and the Company's employees committee that the Company employees would receive compensation in respect of the privatization of the Company. In this framework, it was agreed that options for Company shares would be allocated to the Company employees in the scope of 4.71% of the Company's share capital by the government, as at the date of transfer of the State's holdings in the Company to Ap.Sb.Ar. Holdings Ltd, and the receipt of the consideration in respect of these shares, i.e. October 11, 2005 (hereinafter: **"the Date of Completion"**). The allocation of the options will be performed as detailed hereunder:

A. Company employees who are entitled to compensation in accordance with the Option Plan –

Company employees who meet one of the following two criteria:

- Employees who have been employed at the Company for at least six months on the Date of Completion (October 11, 2005)
- Employees who had been employed at the Company for at least six months before May 24, 2004 (the date on which the Company published a prospectus) and ceased to be Company employees after that date but before the Date of Completion (October 11, 2005)

(Hereinafter: all of the above – **"Entitled Employees"**)

B. Quantity – the Entitled Employees will be offered options for shares in the quantity of 4.71% of the Company's share capital, i.e. **122,697,648** shares that are owned by the State of Israel.

C. The Option Plan period – the effective date for the implementation of the option plan is November 15, 2005 (hereinafter: **"the Effective Date"**), the period of the plan is for four years and until 20 business days from the Effective Date, i.e. until December 12, 2009.

D. The price at which the options will be offered to the employees – the exercise price was set according to a rate of NIS 4.037 in accordance with the terms of the plan (hereinafter: **"the Exercise Price"**).

E. Linkage mechanism – during the period of the arrangement, the Exercise Price will be linked to the Consumer Price Index of September 2005 in the matter of setting the price and the adjustments for the distribution of dividends by the Company and for the issuing of preferred shares and for the preferred component in the issuing of rights.

F. The dates on which the Entitled Employees will be permitted to exercise the options –

Until January 1, 2008, **the options will be blocked** and the Entitled Employees will not be permitted to exercise them. Thereafter, the options will be released in three lots, as follows:

- Beginning on January 1, 2008, each of the Entitled Employees will be entitled to exercise one third of the options offered to him (**"Lot A"**), at any time from this date and until December 12, 2009.
- Beginning on November 14, 2008 (at the end of the third year from the Effective Date), each of the Entitled Employees will be entitled to exercise an additional third of the total quantity of options (**"Lot B"**), at any time from this date and until December 12, 2009.
- Beginning on November 14, 2009 (at the end of the fourth year from the Effective Date), each of the Entitled Employees will be entitled to exercise an additional third of the total quantity of options (**"Lot C"**), at any time from this date and until December 12, 2009.

If an Entitled Employee did not exercise options as per his entitlement in a specific lot, the options will be added to the next lot.

G. Negotiability – the options are nonnegotiable throughout their lifetime, i.e. an Entitled Employee cannot sell his options. Should an Entitled Employee not exercise his entitlement under the arrangement, his entitlement will not be transferred to another Entitled Employee.

H. Trustee – the rights of the Entitled Employees under the arrangement will be transferred to a trustee whose identity is approved by the Tax Authority, subject to the trustee not having more rights than the Entitled Employees have under this arrangement, apart from those rights and obligations stemming from his function as trustee.

I. Distribution of the offered shares among the Entitled Employees – the shares that are offered to the Entitled Employees under the arrangement will be distributed among them on a pro rata basis, according to the value of each employee's monthly salary (the salary in respect whereof National Insurance fees are paid), plus 2% in respect of each year of seniority. The monthly salary will be calculated as the average of the salaries that were paid to each Entitled Employee during the six months preceding the Date of Completion and, with regard to employees who have left the Company, the salary for the last six months preceding May 24, 2004 (the date on which a prospectus was published).

Methodology for Evaluating the Options

There are a number of models for evaluating options, which can be divided into two groups: closed models, the best known of which is the Black & Scholes Model (hereinafter: **"the Black & Scholes Model"**) and network models such as the binomial model, the Monte Carlo model and the like.

Closed Models

The Black & Scholes Model, which was developed by Fisher Black and Marion Scholes and first published in 1973, is the most widespread and accepted model for pricing options. The model's great advantage lies in the fact that it is simple and convenient to use. On the other hand, the formula is rigid and therefore does not permit a change in the parameters over the period.

Network Models

Network models such as the binomial model and the Monte Carlo model are more flexible than the Black & Scholes Model since they are built according to the "decision tree" method and therefore they take various natural states into consideration and permit a change in the parameters over the period, such as: the interest rate, standard deviation and/or the effect of the vesting period, forfeiture after the vesting period, early exercise of the options and more. On the other hand, the network models are more complex and more difficult to implement and are suitable when the terms of the option are "special."

Since the options that are granted do not include a vesting period and/or forfeiture, and are simple options in nature, **we chose to implement the Black & Scholes Model in our valuation of the options**. It should be noted that Accounting Standard 24 and International Accounting Standard 2 (IFRS 2) permit the use of this model.

The Black & Scholes Model

In accordance with the requirements of the relevant accounting standards, the Black & Scholes Model takes six variables that affect the value of the options into consideration, as follows:

- The exercise price of the option
- The current price of the base share
- The lifetime of the option
- The risk-free interest rate
- The volatility and standard deviation of the share's yield
- The anticipated dividend

In order to evaluate the options, we will address each of the following components, as detailed above.

Valuation of the Options

As stated, we chose to evaluate the options using the Black & Scholes Model. The parameters that constituted the basis for calculation are as follows:

The Price of the Base Share

The price of the base share was calculated according to the rate of the Bezeq share on the Date of Completion – on November 10, 2005, i.e. a share rate of NIS 6.40.

The Exercise Price

The exercise price as it was set in the terms of the option, i.e. NIS 4.037.

The Anticipated Dividend

The options that are distributed are protected from the distribution of a dividend and preferred shares, so that there is no need to take this parameter into consideration in calculating their value.

The Lifetime of the Option

The lifetime of the contractual option is approximately four years. However, based on past experience at other companies, holders of options, and employees in particular, tend to exercise the options at an earlier period, in many cases in the initial days when doing so is possible. This stems, *inter alia*, from the employees' dislike of risks, the nonnegotiability of the options, the employees' need for cash and the fact that in many cases they see this as a substitute for a pecuniary bonus that is received in cash.

The options that are granted are pecuniary options, so that in reality they can be exercised with an economic benefit (with a high probability) at any point in time (after the blockage). A large portion of the option recipients are employees whose salaries are not high. For them, exercising the options will constitute a solution to their pecuniary needs.

Bezeq has no past experience with regard to the option exercise period. Additionally, sufficient data regarding the actual exercise period at other companies has not yet been accumulated in Israel. As an aside, we would like to note that in the case of shares that were given to bank employees (in the framework of privatization), it was possible to foresee a material exercise during the initial days after the release of the blockage (in cases where the employees made a profit). In light of the above, it appears to us that the exercise period should be a period that takes all the aforementioned factors into consideration.

In the American standards on the subject the United States Securities Exchange Commission proposed a simplistic way of determining the lifetime of the option in these cases of simple options, in the commentary on Staff Accounting Bulletin no. 107, entitled Certain Assumptions Used in Valuation Methods (SAB 107). According to the method proposed in SAB 107, the period will be the average of the vesting period and the contractual period of the options. While the American standards do not apply in our case, in our opinion the logic and reasoning behind the method that was chosen in this bulletin are also suitable for the option plan for Bezeq's employees. In our case, there is no vesting period but, on the other hand, there is a blockage period.

Therefore, the anticipated lifetime of the option was calculated based on the average of each lot separately, as follows:

- For Lot A, the average period between the period up to the date of release from blockage (January 1, 2008) and the period up to the date of release from blockage of Lot B (November 14, 2008) was used. This calculation is based, *inter alia*, on the assumption that this is the first lot of options and that the employees waited for its release from blockage for over two years, and that there are two additional lots of options of a similar scope waiting for them in the future.
- For Lot B, the average period between the period up to the date of release from blockage and the period up to the expiry date of the options (which is close to the date of release from blockage of Lot C) was used.
- For Lot C, the complete contractual period that corresponds (almost) to the period up to the date of release from blockage of the options was used.

Period	Lot A	Lot B	Lot C
Effective Date	November 15, 2005	November 15, 2005	November 15, 2005
Release from blockage	January 1, 2008	November 14, 2008	November 14, 2009
Expiry	December 12, 2009	December 12, 2009	December 12, 2009
Period until the possibility of exercise	2.13	3.00	4.00
Period up to exercise (years) – contractual	4.08	4.08	4.08
Period up to exercise (years) – anticipated	**2.56**	**3.54**	**4.08**

Risk-free Interest

The risk-free interest was evaluated according to the interest on linked government bonds for the anticipated period of the options, i.e. for a period of around two and a half to four years. **Accordingly, the risk-free interest is 2.45%** (Galil type bonds, series 5416, 5417, 5418, 5419, 5420, 5421 and 5422).

Volatility and Standard Deviation of the Share's Yield

The anticipated standard deviation of the share's yield was based on the historical standard deviation of the Company's shares in recent years. The Company has been traded on the Stock Exchange since 1990, and the trading turnovers of the Company's shares are high. Additionally, the Company has no negotiable options for the Company's shares. In light of the above, it appears to us that the historical standard deviation of the share's yield could serve as a suitable basis for estimating the anticipated standard deviation.

We chose the standard deviation of the Company's share for a period of two to four years, based on daily observations (weekly observations produced similar results). Additionally, we checked whether a change occurred in the standard deviation of late, i.e. during short periods of up to one year, as follows:

	SD one year	SD two years	SD three years	SD four years
Bezeq's share	23.7	22.0	24.8	25.6

We found that during the period (six months to one year) immediately preceding the performance of the calculation, the standard deviation is not materially different from the standard deviation over a longer period. However, in our opinion the standard deviation for three and four years is a more accurate reflection of the estimated standard deviation of the Company's share during the anticipated period of 2.56 – 4.08 years. **Accordingly, the standard deviation that was used is for a range of 25.00% - 25.5%.**

Blockage of the Options and Nonnegotiability

The Black & Scholes Model, like most of the models for evaluating options, is based on the assumption that it is possible to trade in the options at all times and to sell them at all times without material costs. The value of a negotiable asset is higher than the value of the same asset that is nonnegotiable, since negotiability makes it possible to realize the asset immediately. This fact is manifested, *inter alia*, in the fact that nonnegotiable assets cannot constitute collateral for loans from banks and from other financing bodies (unlike ordinary shares, which constitute collateral).

The options that are granted to Bezeq employees are completely nonnegotiable, i.e. the employees cannot trade in them throughout the options' lifetime (four years) and, in addition, they are blocked for a time period of around two to four years, during which the employees cannot exercise them. In other words, the options that the employees receive are a completely non-liquid and nonnegotiable asset, since they cannot be transferred or exercised during the period of the initial two to four years. Thereafter, they are an asset with limited negotiability, since they can be exercised but not traded.

As we were told, according to the Israel Securities Authority's interpretation of Accounting Standard 24 and International Accounting Standard 2 (IFRS 2), no discounting is to be performed in respect of the nonnegotiability or blockage of employee options. In light of the above, in our use of the model we have disregarded the effects of the blockage and nonnegotiability.

List of the Option Calculations

Following is a list of the option calculations as at October 11, 2005:

	Lot A	Lot B	Lot C
Base share price	6.400	6.400	6.400
Exercise price	4.037	4.037	4.037
Period until exercise (years) – contractual	4.08	4.08	4.08
Period until exercise (years) – anticipated	2.56	3.54	4.08
Risk-free interest	2.45%	2.45%	2.45%
Standard deviation	25.00%	25.25%	25.50%
Option value using the B&S method – (NIS)	**2.696**	**2.838**	**2.918**
Number of shares	40,899,216	40,899,216	40,899,216
Value of benefit (NIS thousands)	110,260	116,087	119,327

As stated, the Entitled Employees will be offered option for shares in the scope of 4.71% of the Company's share capital, i.e. **122,697,648 shares and, accordingly, the value of the benefit is around NIS 345,674 thousand.**

Sensitivity Analysis

It is evident from the sensitivity analysis for the main parameters that we used: the risk-free interest rate, the standard deviation and the anticipated lifetime of the option, that **none of the parameters has a material effect on the value of the options.** This stems mainly from the fact that the options are "deep in the money."

Sensitivity Analysis – the Parameter that was changed	**Lot A**	**Lot B**	**Lot C**
Risk-free interest: + 0.5%	2.738	2.892	2.97
Risk-free interest: - 0.5%	2.654	2.785	2.858
Standard deviation: +1.0%	2.709	2.857	2.939
Standard deviation: -1.0%	2.683	2.821	2.897
Anticipated lifetime: + 0.5 years	2.767	2.907	2.985
Anticipated lifetime: - 0.5 years	2.623	2.768	2.848

Sensitivity Analysis – the effect as a percentage	**Lot A**	**Lot B**	**Lot C**
Risk-free interest: + 0.5%	1.6%	1.9%	2.0%
Risk-free interest: - 0.5%	- 1.6%	- 1.9%	- 2.0%
Standard deviation: +1.0%	0.5%	0.7%	0.7%
Standard deviation: -1.0%	- 0.5%	- 0.6%	- 0.7%
Anticipated lifetime: + 0.5 years	2.7%	2.4%	2.3%
Anticipated lifetime: - 0.5 years	- 2.7%	- 2.5%	- 2.4%

Prof. Aranya & Co.

Financial Consultants Ltd.

8 Shaul Hamelech Blvd.
Tel Aviv 64733
Tel: 03-6938322
Fax: 03-6938323

Tel Aviv, March 28, 2007

Bezeq the Israel Telecommunication Corporation Ltd
Azriely Center, the Triangle Building
Tel Aviv

Re: Valuation – Employee Options that were granted by the Company

Dear Sir,

We were asked by Bezeq the Israel Telecommunication Corporation Ltd (hereinafter: **"the Company"** and/or **"Bezeq"**) to express our professional opinion with regard to the fair value of the options for Company shares, which were granted to the employees of the Company by the State of Israel at the end of March 2007, in order to record the value of the benefit as an expense in Bezeq's books.

The opinion examines the fair economic value of the options in accordance with the requirements of Accounting Standard 24 and International Accounting Standard 2 (IFRS 2).

In order to prepare our opinion we relied on data that we received from the Company and we assumed that the said data was correct, accurate and complete. In order to prepare our opinion we perused the following documents, *inter alia*:

- An outline of the Company's securities offering to the employees of the Bezeq Group dated February 22, 2007
- Details about the negotiability of Bezeq's share at the Tel Aviv Stock Exchange
- Details about the yield on State of Israel Bonds
- Any other document and datum which, in our opinion, was required for the purposes of this opinion.

The information that we received from the Company appeared to us to be reliable. However, we did not independently examine and/or verify the data that we were given, apart from general reasonability tests, and the responsibility for them applies to the Company alone. Prof. Aranya & Co. is not responsible for the data, the integrity thereof and the accuracy thereof.

In order to prepare the opinion we met/spoke with representatives of the Company from the areas of finance, budget and financing, and we obtained comments from the Company's legal advisors.

We hereby confirm that we have no personal interest in Bezeq, and that we have no personal interest in the deal that is described. No dependence or connection as defined in Section 240 (B) of the Companies Law, 5759 – 1999 exists between us and the Company and interested parties in the Company, and our fee is not contingent on the results of the opinion.

In connection with the opinion, Bezeq undertook as follows vis-à-vis Prof. Aranya & Co Financial Consultants Ltd: Should Prof. Aranya & Co Financial Consultants Ltd and/or any of the managers thereof and/or the employees thereof (hereinafter: **"Aranya & Co"**) be ordered in the framework of legal proceedings to pay any sum whatsoever to a third party, including to shareholders, in connection with the opinion of fairness that was prepared by Aranya & Co with regard to the value of the options for shares of Bezeq the Israel Telecommunication Corporation Ltd (hereinafter: **"Bezeq"**) that were granted to the Company employees by the State of Israel (hereinafter: **"the Opinion"**), and the services that were provided with regard thereto, Bezeq will indemnify Aranya & Co in respect of any sum that it is ordered to pay as stated, and in respect of reasonable expenses (taking into account the scope of the proceedings and the attorneys and advisors who are appointed to handle the matter) that Aranya & Co expends or is required to expend for legal representation, legal advice, defense from legal proceedings, negotiations and the like, in connection with any claim, demand or other proceedings whose cause stems from or is in any way related to

the aforementioned Opinion, and to which the obligation of indemnification as per this statement applies. The obligation of indemnification will not apply if it is determined that Aranya & Co acted negligently or maliciously in connection with the Opinion or the services that were provided in connection therewith.

We hereby agree that this Opinion will be included and/or referenced in an outline of the allocation of shares to employees, an immediate report that is issued in connection with the options by Bezeq under the Securities (Details of an Outline of an Offer of Securities of Employees) Regulations, 5760-2000 and under the Securities (Periodic and Immediate Statements) Regulations, 5730 – 1970, or any statute that will supersede them, replace them and/or add to them, including in any amended immediate report and/or in the financial statements and/or in any other report that Bezeq is required to submit under any law. Additionally, Bezeq will be entitled to make use of the Opinion before any person, body and authority, as it shall see fit.

Sincerely yours,

Nissim Aranya[1] Benny Hoch[1]

Prof. Aranya & Co – Financial Consultants Ltd

[1] Following are the details of our education:

Prof. Nissim Aranya holds an undergraduate degree in Economics from Hebrew University and an MBA from New York University. He earned his doctorate at the London School of Economics and is a Certified Public Accountant in Israel.

Benny Hoch holds an undergraduate degree in Economics and Accounting, an MBA and an LLM, all from Bar Ilan University. He graduated from the real estate appraisal program at Tel Aviv University and is a Certified Public Accountant in Israel.

Valuation of the Bezeq Options

Background

In the framework of a new collective agreement that was signed on December 5, 2006 between Bezeq the Israel Telecommunication Corporation Ltd (hereinafter: **"the Company"** and/or **"Bezeq"** as defined above) and the Bezeq employees union and the New General Federation of Labor in Israel (the "Histadrut"), it was agreed the Company share options would be allocated to the Company employees in the scope of around 3% of the Company's capital. The allocation of the options will be performed as detailed hereunder:

A. Company employees who are entitled to compensation in accordance with the Option Plan –

Company employees (who are not members of the senor management) who meet one of the following two criteria:

- Employees who are employed at the Company on the date of issue of the options, provided they began working at the Company no later than May 1, 2005.
- Those who were veteran permanent employees or transferred senior employees (as these terms are defined in the Company's collective agreement dated December 5, 2006) on July 1, 2006.

(Hereinafter: all of the above – **"Entitled Employees"**)

B. Quantity – the Entitled Employees will be offered options for shares in the quantity of 3.00% of the Company's share capital, i.e. **78,151,368 shares**.

C. The Option Plan period – the option plan is for a period of five years from the date of allocation of the options to the employees.

D. The price at which the options will be offered to the employees – the exercise price will be 50% of the last closing price of Bezeq's share on the date of allocation of the options (hereinafter: **"the Exercise Price"**).

E. Linkage mechanism – during the period of the arrangement, the Exercise Price will be linked to the Consumer Price Index of February 2007 in the matter of setting the price and the adjustments for the distribution of dividends by the Company and for the issuing of preferred shares and for the preferred component in the issuing of rights.

F. The dates on which the Entitled Employees will be permitted to exercise the options – during the first two years from the date of the allocation, the options will be blocked and the Entitled Employees will not be permitted to exercise them. Thereafter, the employees will be able to exercise the options for three years.

G. Negotiability – the options are nonnegotiable throughout their lifetime, i.e. an Entitled Employee cannot sell his options. Should an Entitled Employee not exercise his entitlement under the arrangement, his entitlement will not be transferred to another Entitled Employee.

H. Trustee – the rights of the Entitled Employees under the arrangement will be transferred to a trustee whose identity is approved by the Tax Authority, subject to the trustee not having more rights than the Entitled Employees have under this arrangement, apart from those rights and obligations stemming from his function as trustee.

I. Distribution of the offered shares among the Entitled Employees – the shares that are offered to the Entitled Employees under the arrangement will be distributed among them on a pro rata basis, according to the value of each employee's monthly salary (the salary in respect whereof National Insurance fees are paid), plus 2% in respect of each year of seniority. The monthly salary will be calculated as the average of the salaries that were paid to each Entitled Employee during the six months preceding the date of issue of the options and, with regard to employees who have left the Company, the salary for the last six months before they left the Company.

Methodology for Evaluating the Options

There are a number of models for evaluating options, which can be divided into two groups: closed models, the best known of which is the Black & Scholes Model (hereinafter: **"the Black & Scholes Model"**) and network models such as the binomial model, the Monte Carlo model and the like.

Closed Models

The Black & Scholes Model, which was developed by Fisher Black and Marion Scholes and first published in 1973, is the most widespread and accepted model for pricing options. The model's great advantage lies in

the fact that it is simple and convenient to use. On the other hand, the formula is rigid and therefore does not permit a change in the parameters over the period.

Network Models

Network models such as the binomial model and the Monte Carlo model are more flexible than the Black & Scholes Model since they are built according to the "decision tree" method and therefore they take various natural states into consideration and permit a change in the parameters over the period, such as: the interest rate, standard deviation and/or the effect of the vesting period, forfeiture after the vesting period, early exercise of the options and more. On the other hand, the network models are more complex and more difficult to implement and are suitable when the terms of the option are "special."

Since the options that are granted do not include a vesting period and/or forfeiture, and are simple options in nature, **we chose to implement the Black & Scholes Model in our valuation of the options**. It should be noted that Accounting Standard 24 and International Accounting Standard 2 (IFRS 2) permit the use of this model.

The Black & Scholes Model

In accordance with the requirements of the relevant accounting standards, the Black & Scholes Model takes six variables that affect the value of the options into consideration, as follows:

- The exercise price of the option
- The current price of the base share
- The lifetime of the option
- The risk-free interest rate
- The volatility and standard deviation of the share's yield
- The anticipated dividend

In order to evaluate the options, we will address each of the following components, as detailed above.

<u>Valuation of the Options</u>

As stated, we chose to evaluate the options using the Black & Scholes Model. The parameters that constituted the basis for calculation are as follows:

The Price of the Base Share

The price of the base share was calculated according to the rate of the Bezeq share on February 21, 2007 (the date on which the Company directorate approved the principles of the plan), i.e. at a rate of NIS 6.678.

The Exercise Price

The exercise price as it was set in the terms of the option, i.e. NIS 3.339.

The Anticipated Dividend

The options that are distributed are protected from the distribution of a dividend and preferred shares, so that there is no need to take this parameter into consideration in calculating their value.

The Lifetime of the Option

The lifetime of the contractual option is five years. However, based on past experience at other companies, holders of options, and employees in particular, tend to exercise the options at an earlier period, in many cases in the initial days when doing so is possible. This stems, *inter alia*, from the employees' hatred of risks, the nonnegotiability of the options, the employees' need for cash and the fact that in many cases they see this as a substitute for a pecuniary bonus that is received in cash.

The options that are granted are pecuniary options, so that in reality they can be exercised with an economic benefit (with a high probability) at any point in time (after the blockage). A large portion of the option recipients are employees whose salaries are not high. For them, exercising the options will constitute a solution to their pecuniary needs.

Bezeq has no past experience with regard to the option exercise period. Additionally, sufficient data regarding the actual exercise period at other companies has not yet been accumulated in Israel. As an aside, we would like to note that in the case of shares that were given to bank employees (in the framework of privatization), it was possible to foresee a material exercise during the initial days after the release of the blockage (in cases where the employees made a profit). In light of the above, it appears to us that the exercise period should be a period that takes all the aforementioned factors into consideration.

In the American standards on the subject the United States Securities Exchange Commission proposed a simplistic way of determining the lifetime of the option in these cases of simple options, in the commentary on Staff Accounting Bulletin no. 107, entitled Certain Assumptions Used in Valuation Methods (SAB 107). According to the method proposed in SAB 107, the period will be the **average** of the vesting period and the contractual period of the options. While the American standards do not apply in our case, in our opinion the logic and reasoning behind the method that was chosen in this bulletin are also suitable for the option plan for Bezeq's employees. In our case, there is no vesting period but, on the other hand, there is a blockage period of two years. Therefore, the lifetime of the option that we chose is the average of: the average of the entire lifetime of the option (there is no vesting period), i.e. 2.5 years and the average of the blockage period and the contractual life of the option, i.e. 3.5 years, **i.e. an average anticipated period of three years**.

Risk-free Interest

The risk-free interest was evaluated according to the interest on linked government bonds for the anticipated period of the options, i.e. for a period of three years. **Accordingly, the risk-free interest is 3.2%** (Galil type bonds, series 5422, 5423 and 5424).

Volatility and Standard Deviation of the Share's Yield

The anticipated standard deviation of the share's yield was based on the historical standard deviation of the Company's shares in recent years. The Company has been traded on the Stock Exchange since 1990, and the trading turnovers of the Company's shares are high. Additionally, the Company has no negotiable options for the Company's shares. In light of the above, it appears to us that the historical standard deviation of the share's yield could serve as a suitable basis for estimating the anticipated standard deviation.

We chose the standard deviation of the Company's share for a period of one year and three years, based on daily observations. Additionally, we checked whether a change occurred in the standard deviation of late, i.e. during periods of one month and six months, as follows:

	SD one month	SD six months	SD one year	SD three years
Bezeq's share	15.2	18.6	20.5	21.6

As one can see in the last period the standard deviation (in the range of one month to six months) is lower than the standard deviation over a longer period. However, in our opinion the average of the standard deviation for one year and for three years is a more accurate reflection of the estimated standard deviation of the Company's share. **Accordingly, the standard deviation that was used is 21%.**

Blockage of the Options and Nonnegotiability

The Black & Scholes Model, like most of the models for evaluating options, is based on the assumption that it is possible to trade in the options at all times and to sell them at all times without material costs. The value of a negotiable asset is higher than the value of the same asset that is nonnegotiable, since negotiability makes it possible to realize the asset immediately. This fact is manifested, *inter alia*, in the fact that nonnegotiable assets cannot constitute collateral for loans from banks and from other financing bodies (unlike ordinary shares, which constitute collateral).

The options that are granted to Bezeq employees are completely nonnegotiable, i.e. the employees cannot trade in them throughout the options' lifetime (four years) and, in addition, they are blocked for a time period of around two to four years, during which the employees cannot exercise them. In other words, the options that the employees receive are a completely non-liquid and nonnegotiable asset, since they cannot be transferred or exercised during the period of the initial two to four years. Thereafter, they are an asset with limited negotiability, since they can be exercised but not traded.

As we were told, according to the Israel Securities Authority's interpretation of Accounting Standard 24 and International Accounting Standard 2 (IFRS 2), no discounting is to be performed in respect of the nonnegotiability or blockage of employee options. In light of the above, in our use of the model we have disregarded the effects of the blockage and nonnegotiability.

List of the Option Calculations

Following is a list of the option calculations as at February 21, 2007:

Parameters	Option Value
Base share price	667.8
Exercise price	333.9
Lifetime of the option (years) – contractual	5.0
Lifetime of the option (years) – anticipated	3.0
Risk-free interest	3.20%
Standard deviation	21.00%
Option value using the B&S method – NIS	**3.6532**

As stated, the Entitled Employees will be offered option for shares in the scope of 3.0% of the Company's share capital, i.e. **78,151,368 shares and, accordingly, the value of the benefit is around NIS 285,500 thousand.**

Sensitivity Analysis

It is evident from the sensitivity analysis for the main parameters that we used: the risk-free interest rate, the standard deviation and the anticipated lifetime of the option, that **none of the parameters has a material effect on the value of the options.** This stems mainly from the fact that the options are "deep in the money."

Sensitivity Analysis – the Parameter that was changed	Option Value	Effect as a %
Risk-free interest: + 0.5%	3.6974	1.2%
Risk-free interest: - 0.5%	3.6085	- 1.2%
Standard deviation: +1.0%	3.6565	0.1%
Standard deviation: -1.0%	3.6446	- 0.2%
Anticipated lifetime: + 0.5 years	3.7056	1.4%
Anticipated lifetime: - 0.5 years	3.6007	- 1.4%

Chapter D – Additional Details About the Corporation

Chapter 4 – Additional Details About the Corporation

1. Summary of the Quarterly Statements of Operations for the Year Ended December 31, 2006 (In NIS millions)

The quarterly financial statements were prepared anew to comply with the International Financial Reporting Standards (IFRS).

	2006	Quarter 4	Quarter 3	Quarter 2	Quarter 1
Revenues	12,232	3,116	3,082	3,019	3,015
Costs and expenses	10,667	3,187	2,532	2,444	2,504
Operating profit	1,565	-71	550	575	511
Financing expenses	338	29	92	146	71
Earnings before Co. equity in affiliates	1,227	-100	458	429	440
Equity in affiliates	11	7	2	1	1
Earnings before income tax	1,238	-93	460	430	441
Income tax	488	21	187	143	137
Net earnings	750	-114	273	287	304
Earnings attributed to Co. shareholders	809	-108	290	308	319
Minority rights in consolidated company	-59	-6	-17	-21	-15

2. Use of Proceeds from Securities with Reference to the Application of the Proceeds According to a Prospectus

No issue has been made on the basis of a Prospectus.

3. List of Investments in Subsidiaries and Related Companies as at the Balance Sheet Date*

Company name	Name of holder	Class of Share	Number of shares	Total par value	Rate of holding in %	Adjusted cost in NIS thousands*	Adjusted balance sheet value in NIS thousands*
Pelephone Communications Ltd.	The Company	Ordinary NIS 1	302,460,000	302,460,000	100%	2,133,375	2,133,375
Bezeq International Ltd.	The Company	Ordinary NIS 0.1	1,000,000,000	100,000,000	100%	246,361	246,361
BezeqCall Communication Ltd.[1]	The Company	Ordinary NIS 1	35,537,220	35,537,220	100%	51,768	51,768
BezeqCall Ltd.[2]	The Company	Ordinary NIS 0.1	400,000,000	40,000,000	100%	0	0
DBS Satellite Services (1998) Ltd.[3]	The Company	Ordinary NIS 1	14,881	14,881	49.80%	1,189,414	1,189,414
Bezeq Online Ltd.[4]	The Company	Ordinary NIS 1	85,000	85,000	100%	24,418	24,418
Bezeq Zahav (Holdings) Ltd.[5]	The Company	Ordinary NIS 1	999,999	999,999	100%	2,082,283	2,082,283
Walla! Communications Ltd.[6]	Bezeq International	Ordinary NIS 1	15,053,880	15,053,880	44.04%[7]	79,559	31,933

Note: Adanet Business Group Ltd. – Adanet and its subsidiaries are in liquidation/receivership proceedings.

* Stated in accordance with IFRS.

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1 The process of merging operations into Bezeq International was completed on 12.2.07.

2 The company is not active.

3 D.B.S. Satellite Services (1998) Ltd. includes an investment of NIS 1,189,414 thousand which was made by means of loans. Of which, NIS 453,580 thousand is in loans linked to the known CPI, NIS 133,020 thousand in loans linked to the known CPI and bearing 5.5% interest, and NIS 602,814 thousand is in loans linked to the known CPI and bearing 11% interest.

4 Bezeq Online Ltd. includes an investment of NIS 1,048 thousand, extended as a shareholder loan. The loan is linked to the CPI and is interest-free.

5 A loan was extended to the subsidiary Bezeq Zahav (Holdings) Ltd. for financing the purchase of Company debentures Series 4 and 5.

6 Walla! Communications Ltd. includes an investment of NIS 872 thousand which was made by means of shareholders' loans from Bezeq International. The loans are linked to the CPI and are interest-free. During 2006, Bezeq International exercised another 2,564,764 options in consideration of NIS 4,616,575 thousand, which was set off from the balance of those loans. The share price on 31.12.06 – 814.7.

7 At full dilution – 33.66%.

4. Changes in Investments in Subsidiaries and Related Companies During the Report Period

Date of the change	Character of the change	Company name	Reported amounts NIS thousands
2/06	Repayment of Shareholder's Loan	Bezeq International	112,893
9/06	Distribution of dividend	Bezeq International	60,000
3/06	Distribution of dividend	Pelephone	300,000
9/06	Distribution of dividend	Pelephone	130,000
12/06	Linkage differentials	DBS	124,295
During 2006	Exercise of option warrants	Walla! Communications Ltd.	There is no transition change between shareholder loans and an investment
12/06	Premium reduction	Bezeq Zahav (Holdings) Ltd.	11,961
12/06	Revaluation	Bezeq Zahav (Holdings) Ltd.	5,827

5. Revenues of Subsidiaries and Related Companies and Revenues of the Corporation from them as at the Balance Sheet Date (In NIS thousands)

Company name	Earnings (loss) before tax	Earnings (loss) after tax	Dividend	Management Fees	Interest
	NIS thousands				
Pelephone Communications Ltd.	682,811	459,247	430,000	0	0
Bezeq International Ltd.	135,951	95,560	60,000	0	0
BezeqCall Communication Ltd.[8]	(16,102)	(13,033)	0	0	0
BezeqCall Ltd.	0	0	0	0	0
D.B.S. Satellite Services (1998) Ltd.	(319,807)	(319,807)	0	0	79,070
Bezeq Online Ltd.	82	3	0	0	997
Bezeq Zahav Holdings Ltd.	0	0	0	0	95,426
Walla! Communications Ltd.	18,014	25,543	0	0	0

6. Stock Exchange Trading – Listed Securities – Dates and Reasons for Termination of Trading

In 2006 no Company securities were listed for trading.

8 The process of merging operations into Bezeq International was completed on 12.2.07.

7. Payment to Senior Officers

Cost of Salary	Total remuneration in NIS thousands (not including Bonus)[9]	Cancelled Bonus[10]
CEO	8,146	2,400
Former Deputy CEO[11]	3,484	640
Chairman	2,840[12]	-
Deputy CEO	2,634	770
VP	1,398	600

8. Salary and Benefits

1. The salary received by the two external directors complies with the maximum tariffs set in the Companies Regulations (Rules Regarding Remuneration and Expenses for an External Director), 5760 – 2000), pursuant to the index as stipulated in said regulations. In 2006 the salary amounted to NIS 167 thousand.
2. The cost of salary of the Chairman of the Board and the CEO NIS 10,986 thousand[9] (not including Bonus[13]).
3. Regarding a management fee agreement, see Note 26(e) to the financial statements.
4. The management fee for 2006 – NIS 5,000 thousand.

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9 The sums include provisions regarding early notice according to agreement, adjustment of compensation and vacation according to actuary calculations

10 Following the application of the Securities Authority regarding the Bonus to senior officers, the Bonuses were cancelled, as clarified in the immediate report as of 26.3.07.

11 Including sums relation to his tenure at subsidiary D.B.S. Satellite Services (1998) Ltd.

12 Includes a one time payment according to his employment agreement.

13 See note 10 above.

9. Shares and Convertible Securities Held by Interested Parties in the Corporation, a Subsidiary or a Related Company, as Close as Possible to the Report Date

	Name of holder	Type of security	Number of convertible securities	Number of shares	Value in NIS par value	Percentage of holding in control and in equity
1.	State of Israel[14]	Ordinary		426,797,766	426,797,766	16.38
2.	Zeevi Communications Holdings Ltd.[15]	Ordinary		459,331,617	459,331,617	17.63
3.	D.E. Dirot Elite Ltd.	Ordinary		3,097,697	3,097,697	0.12
4.	Ap.Sb.Ar. Holdings Ltd. through Romema Investments Co. Ltd.[16]	Ordinary		781,513,683	781,513,683	30.00
5.	Ran Gottfried (director)	Ordinary		12,000	12,000	
6.	Rami Nomkin[17] (director)	Ordinary	53,920		53,920	
7.	Yehuda Porat.[18] (director)	Ordinary	23,269		23,269	

10. Registered Capital, Issued Capital and Convertible Securities

The registered capital 2,749,000,000 shares of NIS 1 par value each
Issued capital 2,605,045,611 shares of NIS 1 par value each, having equal rights.
78,091,794[19] options to employees for shares of the Company of NIS 1 par value each, in accordance with an outline dated 22.2.07, were allocated on 25.3.07.
There are no dormant shares.

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14 In accordance with the agreement between Ap.Sb.Ar Holdings Ltd. and the State for the purchase of the State's holdings in the Company, Ap.Sb.Ar Holdings Ltd. has an option to purchase up to 277,697,862 shares in the Company (which constitute approximately 10.66% of the Company's share capital), which can be exercised until the first business day occurring 48 months after October 11, 2005 (the date of closing the purchase of the Company's shares). Under the aforesaid agreement, Ap.Sb.Ar. Holdings Ltd. will be entitled to request that the State vote with it (within the limits defined in the agreement concerning certain matters) for 10.66% of the Company's shares held by the State and for which Ap.Sb.Ar. Holdings Ltd. received an option to purchase, and for 1.01% of the Company's shares which will remain in the State's hands in the period commencing on October 11, 2005 (the date of closing the transaction) and ending at the end of the option exercise period as aforesaid, and for 4.71% of the Company's shares held by the State, which are designated for allotment to Company employees – for a period as aforesaid or until the transfer of ownership of those shares to Company employees, the earlier of the two.

15 On November 12, 2002, a receiver was appointed to this company, Adv. Alex Hartman, who is authorized to exercise the rights in respect of the Company's shares in accordance with the ruling and approval of the court. It should be noted that this company belongs to the Zeevi Group. Another company of the same group, D.E. Dirot Elite Ltd., (as specified in Section 3) also holds shares in the Company.

16 See Note 14 above

17 Options allotted to the director from among the employees according to an outline dated 15.11.05. In addition, 39,862 options will be allotted to the director, according to an outline for employees dated 22.2.07, after and subject to the approval of the general meeting scheduled for 15.4.07.

18 Options allotted to the director from among the employees according to an outline dated 15.11.05. In addition, 19,712 options will be allotted to the director, according to an outline for employees dated 22.2.07, after and subject to the approval of the general meeting scheduled for 15.4.07.

19 See Notes 17 and 18 above.

11. Registered Address of the Corporation

Address: 132 Menahem Begin Street, Azrieli Center (The Triangular Tower), Tel Aviv
Telephone 1: 03-6262200; Telephone 2: 03-6262300; Fax: 03-6262209
email: Bosmatch@Bezeq.com (General Counsel and corporate secretary)

12. Directors of the Corporation

A.
(1) **Dov Weissglas** ID. No. 07853815
(2) Date of birth: October 4, 1946
(3) Address: 44 Lilienblum Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Chairman of the Security Committee and Chairman of the Committee for Regulation Issues[20]
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
The director is Chairman of the Company's Board of Directors (as of July 12, 2006)
(8) Date of start of tenure as a director: June 21, 2006
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
LLB Tel Aviv branch of the Hebrew University of Jerusalem
May 1, 2002 – August 1, 2004 – Head of Prime Minister's Bureau
August 1, 2004 – June 1, 2006 – Special Adviser to the Prime Minister
Since 1971 – Lawyer
Director at:
Bezeq International Ltd.
Pelephone Communications Ltd.
D.B.S. Satellite Services (1998) Ltd.
(10) Related to an interested party in the Corporation: No

B.
(1) Name: **Moshe (Mori) Arkin*** ID. No. 051643062
(2) Date of birth: October 23, 1952
(3) Address: 22 Derech Haganim, Kfar Shmaryahu
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: member of the Security Committee and the Committee for Regulation Issues
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: October 11, 2005 (until July 12, 2006 served as Chairman of the Company's Board of Directors)
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA – Psychology, Tel Aviv University
BA – Philosophy, Tel Aviv University
1983-2005 – Chairman of the Board of Agis Industries (1983) Ltd.
From 2005 – Deputy Chairman of the Board of Frigo.
From 2001 – President of Agis Industries (1983) Ltd.
Until 2001 – CEO of Agis Industries (1983) Ltd.
Director at:
D.B.S. Satellite Services (1998) Ltd. (until September 17, 2006)
Ap.Sb.Ar. Holdings Ltd.
Arkin Communications Ltd.
Frigo
M. Arkin (1999) Ltd.
Arkin Real Estate Holdings (1981) Ltd.
Arkin-Yanai Holdings Ltd.
Arkin Assets Ltd.

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20 The Committee for Regulation Issues is a joint committee of members of the Board and Management, established to advise and make recommendations to the Board of Directors on the subject of regulation.

Moshe and Daniela Arkin Promotions and Investments Ltd.
(10) Related to an interested party in the Corporation: No

* Arkin Communications Ltd., which is wholly owned by Moshe Arkin, owns 10% of the capital and 19% of the voting rights of Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd.)

C. (1) Name: **Pinchas (Barel) Buchris** ID No. 053305868
(2) Date of birth: April 11, 1956
(3) Address: Museum Tower, 4 Berkowitz Street, Tel Aviv 64238
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Security Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is an independent partner in the Apax Israel Investment Fund.
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
B.Sc. – The Technion, Israel Institute of Technology
MBA – Derby University
From 2003 – Independent partner in the Apax Israel Investment Fund
Director at:
Protalix
Gmn
Raysat
Storewiz
A. Nuriel Knafaim Holdings
(10) Related to an interested party in the Corporation: No

D. (1) Name**: Ran Gottfried** ID No. 006357206
(2) Date of birth: August 20, 1944
(3) Address: 64 Pinkas Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: November 24, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
Completed two years undergraduate degree studies in Economics and Social Sciences at Tel Aviv University
From November 2005 – independent adviser at Magnolia Silver Jewelry and Magnolia Export Logistics Ltd.
2001-November 2005 Chairman of the Board of Magnolia Silver Jewelry Ltd.
2003-November 2005 CEO and partner Magnolia Export Logistics Ltd.
From 2004 to the present – independent adviser at Careline-Neca
From 2000 to the present – independent adviser – strategic consultation to retail companies in Israel and abroad
2000-2002 – Strategic advice to cosmetic companies abroad
1998-2000 – CEO and partner of NewPharm
1995-2000 – CEO and partner of April Ltd.
Director at:
2003-2005 Director in Agis
Since 2006 Director in Frigo
(10) Related to an interested party in the Corporation: No

E. (1) Name: **Michael Grabiner** ID. No. 800111117
(2) Date of birth: August 21, 1950
(3) Address: 35 Uphill Road, London NW7 4RA, UK
(4) Citizenship: British
(5) Membership of Board of Directors Committees: Member of the Committee for Regulation Issues

(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: Partner in Apax Partners LLP
(8) Date of start of tenure as a director: June 21, 2006
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
MA Economics and Politics, Cambridge University
From February 2002, Partner, Apax Partners Worldwide LLP
Director at:
Spectrum Strategy Consultants Ltd.
Partnership for Schools Ltd
Synetrix Holding Ltd.
Nexagent Ltd
(10) Related to an interested party in the Corporation: No

F. (1) Name: **Zehavit Cohen** ID. No. 058344797
(2) Date of birth: November 16, 1963
(3) Address: 4 Berkowitz st. Museum Tower, Tel-Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Audit Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: CEO of Apax Partners Israel Ltd.
(8) Date of start of tenure as a director: June 21, 2006
(9) Education and employment during the past five years and details of the corporations in which she serves as director:
BA Accounting, Duquesne University
MA Finance - University of Pittsburgh
MA ABD Accounting, University of Pennsylvania
PhD Finance La Salle University
From 1998 – Lecturer in Finance and Accounting, University of Pennsylvania
From 1998 – Deputy CEO and Chief Financial Officer, IDB Development Company Ltd.
From 2003 - Chief Financial Officer, IDB Holdings Company Ltd.
From 1998 - Deputy CEO and Chief Financial Officer, IDB Holdings Company Ltd.
From 2006 – CEO, Apax Israel
(10) Related to an interested party in the Corporation: No
(11) The Company considers the director to have accounting and financial expertise

G. (1) Name**: Menachem Inbar** ID. No. 000483982
(2) Date of birth: September 3, 1948
(3) Address: 5 Hagilad Street, Ramat Gan
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Chairman of the Audit Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director assists Moshe Arkin, who is an interested party in the Company, in managing his investments
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Social Sciences, Bar Ilan University
Since 2000 – partner manager in Shifman-Inbar Ltd.
Director at:
DBS Satellite Services (1998) Ltd.
Alrov Israel Ltd.
Arkin Communications Ltd.
Shifman-Inbar Ltd.
Mobile Solid Ltd.
(10) Related to an interested party in the Corporation: No
(11) The Company considers the director to have accounting and financial expertise

H. (1) Name: **Adam Chesnoff*** ID. No. 022113567
(2) Date of birth: November 15, 1965

(3) Address: 226S. Saltair Avenue, Los Angeles, CA 90049
(4) Citizenship: Israeli and American
(5) Membership of Board of Directors Committees: Member of the Committee for Regulation Issues
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is President and Chief Operating Officer of SCG Israel Ventures LLC, which owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd)
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics and Management, Tel Aviv University
MBA, Business School, UCLA
From 1999 President and Chief Operating Officer at Saban Capital Group
Director at:
Prosieben SAT 1 Media A6 (Germany)
KSF Corp, (incorporated in Delaware)
(10) Related to an interested party in the Corporation: No
(11) The Company considers the director to have accounting and financial expertise
* Adam Chesnoff holds 2.025% of SCG Israel Ventures Ltd.
SCG Israel Ventures LLC owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd.)

I. (1) Name: **David Blumberg** ID No. 6184626
(2) Date of birth: September 12, 1944
(3) Address: 18 Uzia Street, Jerusalem
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Member of the Audit Committee
(6) External Director: Yes. Has accounting and financial expertise.
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: February 1, 2007
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics – Hebrew University of Jerusalem
MBA - Hebrew University of Jerusalem
1997 – 2005, Chairman, Board of Directors, Bank of Jerusalem
From 2006 – owner of financial consultancy company
Director at:
B.S.S.CH – Israel Credit Insurance Company
(10) Related to an interested party in the Corporation: No
(11) The Company considers the director to have accounting and financial expertise

J. (1) Name: **Dr Eyal Yaniv** ID. No. 056540644
(2) Date of birth: June 21, 1960
(3) Address: 38 Hakinor Street, Petah Tikva
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Audit Committee, Security Committee
(6) External Director: Yes. Has professional qualification
(7) Employee of the corporation, a subsidiary, related company or interested party:
(8) Date of start of tenure as a director: February 1, 2007
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Psychology and Computer Sciences – Bar Ilan University
MBA Psychology - Bar Ilan University
PhD Business Administration, Bar Ilan University
LLB – Kirya Akademit, Kiryat Ono
Until 2002, CEO, Nonstop
From 2002 strategic marketing consultant and personal trainer for managers

From 2003 – head of executive MBA program and lecturer in Business Administration (strategy, entrepreneurship and marketing) at Bar Ilan University and Hebrew University of Jerusalem
Director of an external corporation: No
(10) Related to an interested party in the Corporation: No

K. (1) Name: **Kihara R. Kiarie** Passport No. 039101782
(2) Date of birth: May 16, 1974
(3) Address: 10100 Santa Monica Blvd. Los Angeles, California 90067, U.S.A.
(4) Citizenship: USA
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is an officer (director) of the Saban Capital Group, a company with an indirect holding in Ap.Sb.Ar. Holdings Ltd.
(8) Date of start of tenure as a director: November 24, 2005
(9) Education and employment during the past five years and details of the corporations in which she serves as director:
BA Economics, Dartmouth College
MBA, Harvard Business School
2003-2006 Saban Capital Group (director)
1999-2001 Associate (partner) in AEA Investors
Director at:
Saban Capital Group
(10) Related to an interested party in the Corporation: No

L. (1) Name: **Arieh Saban** ID No. 064902083
(2) Date of birth: May 2, 1947
(3) Address: 59 Kaplan Street, Herzliya
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
From 2001 – partner in the Fox Kids Channel. He sold all his holdings in December 2002.
For 15 years distributed and marketed children's television programs through Israel Audio Visual Corp.
Director at:
Keshet Broadcasting Ltd.
(10) Related to an interested party in the Corporation: Yes
The director is the brother of Haim Saban. Haim Saban is the controlling shareholder of SCG Israel Ventures LLC, which owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd)

M. (1) Name: **Yoav Rubinstein** ID No. 16447153
(2) Date of birth: May 17, 1973
(3) Address: Apartment 28, 2 Kehilat Venezia Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director is the investment manager of Apax Israel Investment Fund
(8) Date of start of tenure as a director: June 21, 2006
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Business Administration – Interdisciplinary Center
From 2000 - Investment Manager, Apax Partners
Director at:
Yellow Green Finance & Investment Ltd.
Purple Green Project & Investment Ltd.

Ap.Sb.Ar. Holdings Ltd.
Ap.Sb.Ar. Cayman Ltd.
Genetrix
(10) Related to an interested party in the Corporation: No

N. (1) Name: **Tomer Guriel** ID No. 28752202
(2) Date of birth: September 5, 1971
(3) Address: Bezeq House, 2 Azrieli Center, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: December 7, 2006
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
MBA Tel Aviv University, Kellogg Recanati
BA in Economics and Finance, Baruch College, New York
From 2005 - Investment Manager and Owner, FE Capital Finances and Investments
1999-2004 investment banking J.P. Morgan Chase & Co.
Director at:
Super Center – SZ Ltd. (Bulgarian company)
(10) Related to an interested party in the Corporation: No

O. (1) Name: **Rami Nomkin** ID No. 042642306
(2) Date of birth: January 14, 1949
(3) Address: 126 Mohilever Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is IP Center Manager in the Business Division
(8) Date of start of tenure as a director: January 17, 2007
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
High School Education
From 2007 - manager of Bezeq's IP center.
From 2001 – Business Center Manager in the Telecommunications Division - Tel Aviv and Sharon Division
2000 – Acting Area Manager, Bezeq - Tel Aviv and Sharon Division
Until October 11, 2005 served as employee-director
Director at another corporation: No
(10) Related to an interested party in the Corporation: No

P. (1) Name: **Yehuda Porat** ID No. 059769455
(2) Date of birth: February 18, 1968
(3) Address: 2 Mevo Haro'im, Har Adar 90836
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is Manager of the Bugging Detection and Special Jobs Department.
(8) Date of start of tenure as a director: January 17, 2007
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
LLB, Hakirya Ha'akademit, Kiryat Ono
Practical Electronic Engineer, Bezeq College, Jerusalem
Member of the Israel Bar Association
Bugging Location and Detection course given by the external advisor to the Security Services
Bugging Detection course – R.E.I., USA
Basic Data Protection for Security Officers course – General Security Services
Interrogation course – General Security Services
Directors in Private and Public Companies course- The Israeli center for management

Advanced Directors course - The Israeli center for management
Analysis of Financial Reports and Corporate Value Assessment course - The Israeli center for management
Qualified Mediator course – Israel Bar Association
From 1999 - Manager of Bezeq's Bugging Detection and Special Jobs Department
Until October 11, 2005 served as employee-director
Director in another corporation: No

(10) Related to an interested party in the Corporation: No

13. Senior Officers of the Corporation

A.
(1) Name: **Yacov Gelbard** ID No. 030256622
(2) Date of birth: May 2, 1947
(3) Date of taking office: October 11, 2005
(4) Position in the Company: CEO
Position in a subsidiary of the Company, in a related company or in an interested party of the Company:
Director at:
BezeqCall Communications Ltd. (until it was merged with Bezeq International Ltd.)
Pelephone Communications Ltd.
Bezeq International Ltd.
D.B.S. Satellite Services (1998) Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics and Accounting, Tel Aviv University, qualified CPA
2001-2005 CEO Pelephone Communications Ltd.
1999-2001 CEO XXL Electronic Trading, Discount Investments

B.
(1) Name: **Yitzhak (Ika) Abravanel** ID No. 52626827
(2) Date of birth: June 29, 1954
(3) Date of taking office: November 16, 2005
(4) Position in the Company: Deputy CEO for fixed-line communication*
Position in a subsidiary of the Company in a related company or in an interested party of the Company:
Director at:
Bezeq International Ltd. (until January 7, 2007)
Pelephone Communications Ltd. (until January 7, 2007)
BezeqCall Communications Ltd. (until it was merged with Bezeq International Ltd.)
Bezeq Online Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Political Science, Haifa University
MA Political Science, Haifa University
Graduate of the National Security College
2001-2005 Senior VP Operations and Customer Service, Pelephone Communications Ltd.

*Appointed as acting CEO on 29/3/07 instead of the CEO who left for vacation, as detailed in the immediate report from that date.

C.
(1) Name: **Eliezer Mizroch** ID No. 025045139
(2) Date of birth: February 1, 1973
(3) Date of taking office: October 1, 2006
(4) Position in the Company: Deputy CEOStrategy and Business Development
Position in a subsidiary of the Company in a related company or in an interested party of the Company:
Director at:
Bezeq International Ltd.
Bezeq Online Ltd (Chairman)
Pelephone Communications Ltd.
D.B.S. Satellite Services (1998) Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Business Administration, Cape Town University, South Africa
1999-2002 – Manager of Strategy Department, Bank Hapoalim Retail Division

2003-2005 – Manager of Center for Strategic Management, Bank Hapoalim
From 2005 - Manager of Marketing and Strategic Planning Department, Bank Hapoalim Retail Division

D. (1) Name: **Ran Oz** ID No. 022832588
(2) Date of birth: December 13, 1966
(3) Date of taking office: January 31, 2007
(4) Position in the Company: Deputy CEO and Chief Financial Officer
Position in a subsidiary of the Company in a related company or in an interested party of the Company:
Director at:
Bezeq International Ltd.
Pelephone Communications Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Accounting and Economics, Hebrew University of Jerusalem
MBA Business Administration and Economics, Hebrew University of Jerusalem
2004-2006 – Senior Vice President and CFO Nice Systems Ltd.
2001-2004 –CFO Ceragon Networks Ltd.

E. (1) Name: **Bosmat Chelouche** ID No. 052592664
(2) Date of birth: May 8, 1954
(3) Date of taking office: Since September 1, 1998, General Counsel, and since November 16, 2005 also as VP and Corporate Secretary
(4) Position in the Company: VP, General Counsel and Corporate Secretary
Position in a subsidiary of the Company in a related company or in an interested party of the Company:
Director at:
BezeqCall Communications Ltd. (until it was merged with Bezeq International Ltd.)
Pelephone Communications Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
LLB, Tel Aviv University
1998-2007 Bezeq General Counsel (since November 16, 2005 also VP and Corporate Secretary)

F. (1) Name: **Michel Hibert** ID No. 068200203
(2) Date of birth: October 26, 1956
(3) Date of taking office: December 5, 2006
(4) Position in the Company: Deputy VP Engineering and Planning
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Electronic Engineering, Ben Gurion University
EMBA Strategy, Hebrew University of Jerusalem
April 1, 2006 – December 4, 2006 –VP Engineering and Planning
August 12, 2004 – March 31, 2006 – Acting VP Engineering and Planning
2003-2004 – Manager of Access Networks Engineering Department, Engineering and Planning Division, Bezeq
1998-2003 – Manager of Access Networks Department, Engineering and Planning Division, Bezeq

G. (1) Name: **Danny Oz** ID No. 054299953
(2) Date of birth: June 16, 1956
(3) Date of taking office: September 1, 1998
(4) Position in the Company: Controller and Deputy CFO
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics and Accounting, Hebrew University of Jerusalem. Licensed CPA
EMBA Integrative Management, Hebrew University of Jerusalem

Since September 1998 – Company Controller

H. (1) Name: **Ran Guron** ID No. 024113268
(2) Date of birth: December 25, 1968
(3) Date of taking office: January 9, 2006
(4) Position in the Company: VP Marketing
Position in a subsidiary of the Company in a related company or in an interested party of the Company:
Director at:
Pelephone Communications Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics, Hebrew University of Jerusalem
MBA, Hebrew University of Jerusalem
2003-2005 VP Marketing, Barak
1997-2002 Marketing Manager, Business Sector, Cellcom

I. (1) Name: **Yuval Rachlevsky** ID No. 030441430
(2) Date of birth: June 22, 1950
(3) Date of taking office: April 1, 2006
(4) Position in the Company: VP Human Resources
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics and International Relations, Hebrew University of Jerusalem
MBA Hebrew University of Jerusalem
LLB Interdisciplinary Center Herzliya
1999-2005 Commissioner for Wages and Labor Agreements in the Treasury

J. (1) Name: **Sharon Fleischer Ben Yehuda** ID No. 028531648
(2) Date of birth: April 25, 1971
(3) Date of taking office: June 1, 2006
(4) Position in the Company: VP Regulation
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Political Science, Hebrew University of Jerusalem
MBA Public Policy and Administration, Hebrew University of Jerusalem
Until May 31, 2006 VP Regulation Pelephone Communications Ltd.
2001-2005 Manager Regulation and Government Relations Department Pelephone Communications Ltd.
1995-2001 Senior Adviser to the Director-General of the Ministry of Communications

K. (1) Name: **Eli Frank** ID No. 053337739
(2) Date of birth: July 6, 1955
(3) Date of taking office: September 19, 2006[21]
(4) Position in the Company: VP Information Systems
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
MBA Tel Aviv University
B.Sc. Mathematics and Computer Science, Bar Ilan University
Professional qualifications (Programming, Systems Analysis, etc.) Mamram [IDF Central Computing Facility]
Since 2004 Information, Strategy and Management Consultant (freelance)
December 2003 - June 2004 –VP and Department Manager Ness Information Technology

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[21] It is clarified that the above date is the date on which Eli Frank took office (and not August 15, 2006, as stated in a report of that date).

Services Group
1999-2003 –VP CRM Systems Supply and Billing Division Amdocs

L. (1) Name: **Malka Dror** ID No. 056524358
(2) Date of birth: July 7, 1960
(3) Date of taking office: August 15, 2006
(4) Position in the Company: Acting Company Controller
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics, Hebrew University of Jerusalem
CISA qualification for the position "Controller of Computer Systems"
Course in Auditing and Information Systems Protection
Course in Information Systems Analysis
From December 2004 - August 15, 2006 served as Manager Audit Department and Deputy Company Controller, Bezeq
1995-2004 – Department Manager, Bezeq

M. (1) Name: **Nissim Alafiya** ID No. 051768000
(2) Date of birth: November 6, 1952
(3) Date of taking office: December 1, 2006
(4) Position in the Company: VP Business Division
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
Communications Engineer, Mississippi Kessler Afb
MA Political Science – Haifa University
From 2006 Consultant in Seker Co.
2002-2005 – President and CEO Netcom
1999-2002 – CEO Tevel Telecom (HOT – Telecom)

N. (1) Name: **Einat Rom** ID No. 022079396
(2) Date of birth: November 17, 1965
(3) Date of taking office: December 5, 2006
(4) Position in the Company: VP Private Customers Division
Position in a subsidiary of the Company in a related company or in an interested party of the Company: Director at the subsidiary Bezeq Online Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Social Sciences – Haifa University
November 2005 – December 5, 2006 – Project Manager Customer Service and Retention (private sector)
2002-2005 –VP Customer Service Pelephone Communications Ltd.
1998-2002 – Manager, Center Department Pelephone Communications Ltd.

O. (1) Name: **Eyal Kamil** ID No. 057248999
(2) Date of birth: August 30, 1961
(3) Date of taking office: December 5, 2006
(4) Position in the Company: VP Operations and Logistics
Position in a subsidiary of the Company in a related company or in an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
B.Sc. Industrial Engineering and Management Tel Aviv University
MBA Tel Aviv University
2005-December 4, 2006 – Manager Change Administration Bezeq
2001-2005 – Manager Organization and Methods Department Pelephone Communication Ltd.

Following are the names of the senior officers who completed their term of service by the date of publication of the periodic report for 2006:

Directors:

Elon Shalev – completed his tenure as director on March 8, 2006

Sachi (Issachar) Gerlitz - completed his tenure as director on April 26, 2006

Stephen Grabiner - completed his tenure as director on May 15, 2006

Chanoch (Alan) Barkat - completed his tenure as director on June 21, 2006

Blanche Kay - completed her tenure as director on January 25, 2007

Yigal Cohen Orgad - completed his tenure as director on January 25, 2007

Senior officers who are not directors:

Rami Hazan - completed his tenure as VP Marketing and Sales on January 1, 2006

Ehud Mezuman - completed his tenure as Acting VP Management Resources on March 31, 2006

Raz Heiferman - completed his tenure as VP Information Technology on August 14, 2006

Danny Friedman - completed his tenure as Internal Auditor on August 14, 2006

Ron Eilon - completed his tenure as Deputy CEO and CFO on August 28, 2006

Shai Ben Yakar - completed his tenure as Acting CFO on January 31, 2007

Erez Hasdai - completed his tenure as Acting VP Economics on January 31, 2007

Note: The list of senior officers above includes the office holders according to the definition of "holder of a senior position" in the Securities Regulations (Periodic and Immediate Reports), 5730-1970.

14. The Auditors of the Corporation

Somekh Chaikin – Certified Public Accountants (Isr.)
Address: 17 Ha'Arba'a Street
Millennium Tower KPMG
Tel Aviv 64739
Tel: 03-6848000

15. Change in the Memorandum or Articles of Association

On December 20, 2006 the General Meeting approved the replacement to the Company's Articles of Association.

On February 1, 2007 the registered capital was increased by 124,000,000 ordinary shares. The Company's Memorandum and Articles were amended accordingly.

16. Recommendations and Resolutions of the Directors Before the General Meeting and their Resolutions which are not Subject to the Approval of the General Meeting

16.1 March 1, 2006 - to recommend to the General Meeting of the Shareholders of the Company the distribution of a cash dividend to the shareholders of the Company, in a total amount of NIS 1,200,000,193 which constitute, as at the date of the distribution, NIS 0.4606446 per share and 46.06446% of the issued and paid up capital of the Company.

16.2 September 14, 2006 – to recommend to the General Meeting of the Shareholders of the Company the distribution of a cash dividend to the shareholders of the Company in a total amount of NIS 400,000,064 (which constitute as at said date NIS 0.1535482 per share).

16.3 November 27, 2006 - to recommend to the General Meeting as follows:

1. To distribute a cash dividend to the shareholders of the Company in a total amount of NIS 300,000,179 which constitute as at said date NIS 0.1151612 per share).

2. To replace the Articles of the Company with new articles (the wording of the proposed articles is attached to the immediate report on the calling of the meeting on that date).

16.4 December 3, 2006 – to recommend to the General Meeting, subject to approval from the court – the distribution of a cash dividend to the shareholders of the Company in a total amount of NIS 1,800,000,030 (which constitute as at said date NIS 0.6909668 per share) in a distribution which does not comply with the earnings test

16.5 December 26, 2006 – to recommend to the General Meeting an increase in the registered capital of the Company by 124,000,000 ordinary shares of NIS 1 par value each, which shall have rights equal to those of the Company's ordinary shares of NIS 1 par value, and to allot options amounting to 5.5% of the Company's issued capital to the employees of the Company and to the senior management of the Group (up to 143,277,509 options are exercisable for 143,277,509 ordinary shares of NIS 1 par value each).

17. Resolutions of a Special General Meeting

17.1 Approval of a recommendation from the Company's Board of Directors regarding distribution to the Company's shareholders of a cash dividend amounting to NIS 1,200,000,193. (Resolution **from March 23, 2006).**

17.2 Approval to enter into a management agreement with a management company which is a company (in the setup phase) owned and controlled by the shareholders of Ap.Sb.Ar. Holdings Ltd. ("Ap.Sb.Ar."). (Resolution from March 23, 2006).

17.3 Approval of the conditions of employment of the chairman. (Resolution from June 21, 2006).

The General Meeting approved the terms of employment of Mr Dov Weissglas who is designated to be appointed chairperson by the Board of Directors. see Note 29(i) to the financial statements.

17.4 Approval of a recommendation from the Company's Board of Directors regarding distribution to the Company's shareholders of a cash dividend amounting to NIS 400,000,064. (Resolution from October 9, 2006).

17.5 Appointment of Mr Tomer Guriel as director. (Resolution from December 7, 2006).

17.6 Approval of a recommendation from the Company's Board of Directors regarding distribution to the Company's shareholders of a cash dividend amounting to NIS 300,000,179. (Resolution from December 20, 2006).

17.7 Replacement of the Company's Articles of Association with new articles. (Resolution from December 20, 2006).

17.8 Approval of distribution to the shareholders of a dividend amounting to NIS 1,800,000,030 which does not comply with the earnings test (with approval from the court). (Resolution from December 28, 2006).

17.9 Appointment of Rami Nomkin and Yehuda Porat as directors from among the employees. (Resolution from January 17, 2007).

17.10 Approval of a commitment to indemnify Company officers in advance. (Resolution from January 17, 2007) for any liability or expense imposed on officers as a result of actions they take in their capacity as officers of the Company, including actions in subsidiaries. The total amount of the indemnity is capped at 25% of the Company's share capital as it shall on the date of indemnification. The undertaking to indemnify shall apply to a list of types of occurrences as set forth in the addendum to the undertaking to indemnify.

17.11 Appointment of David Blumberg and Eyal Yaniv as external directors for a period of three years. (Resolution from February 1, 2007).

17.12 Approval of the terms of tenure of the external directors in accordance with the maximum tariffs set in the Company's Articles (Rules Regarding Remuneration and Expenses for an External Director), 5760 – 2000), including the granting of an undertaking to indemnify in advance. (Resolution from February 1, 2007).

17.13 Approval of an increase in the Company's registered capital by 124,000,000 ordinary shares of NIS 1 par value and a corresponding amendment to the Company's Memorandum and Articles. (Resolution from February 1, 2007).

17.14 Approval of the allotment of options and shares resulting from their exercise to the Company's employees and Group's senior management amounting to 5.5% of the Company's issued capital (143,277,509 options exercisable for 143,277,509 ordinary shares of NIS 1 par value each). (Resolution from February 1, 2007).

18. Transactions Requiring Special Approvals

Approval to enter into a management agreement with a management company which is a company (in the setup phase) owned and controlled by the shareholders of Ap.Sb.Ar. Holdings Ltd. ("Ap.Sb.Ar."). Resolutions in connection with this matter were passed by the Audit Committee on March 8, 2006, by the Board on March 13, 2006 and by the General Meeting on March 23, 2006.

19. Valid Insurances and Indemnities

Insurance

A resolution from May 16, 2005 regarding approval of the exercise of an option for the purchase of a run-off policy covering the liability of Company officers by virtue of which a run-off insurance policy was issued covering the liability of officers who served in the Company until the date of transfer of control, October 11, 2005, for a period of seven years from said date.

Resolution from August 3, 2005 regarding the extension of an officers' insurance policy including the run off option, for a period of up to four months.

Resolution from November 24, 2005 regarding approval of an agreement with Clal Insurance Company Ltd. to purchase a liability insurance policy for the Company's officers and approval of a "framework transaction" for a further two years to enter into agreement regarding future insurance policies.

The Board approved an agreement with Clal Insurance Company Ltd. for the purchases of an officers' liability insurance policy for one year from October 11, 2005 with a claim liability limit totaling 150 million dollars for each year of insurance. In addition, 30 million dollars per claim for all claims in the period of insurance for legal expenses in Israel only. The limit of liability for subsidiaries – 50 million dollars (as part of the above-mentioned limit of liability). Annual premium – 675,000 dollars + 1.5% stamp duty.

The Board also approved a "framework transaction" starting on the date of approval by the General Meeting for two years from the date of expiration of the current policy, for the Company to enter into an agreement as part of its normal course of business, regarding future insurance policies, valid (after expiration of the above-mentioned insurance policies) for coverage of the liability of directors and officers, as they shall be from time to time, including directors and officers who are or who are likely to be considered controlling parties in the Company, all by way of a "framework transaction" as defined in the Companies Regulations (Reliefs in Transactions with Interested Parties) 5760-2000 with an annual premium amounting to US $675,000 plus a sum constituting 20% of said premium for the insurance cover amount currently existing (as set forth above) and 30 million dollars per claim for all claims in the period of insurance for legal expenses in Israel only. The limit of liability for subsidiaries – 50 million dollars (as part of the above-mentioned limit of liability).

If insurance cover is purchased in an amount different from the amount of the current insurance cover, the option of increasing the premium is capped at 20% of the premium for the current policy (US$ 675,000). In other words, the maximum premium (after the increase) shall not exceed US$ 810,000 for any occurrence.

Indemnification

A resolution from January 17, 2007 concerning approval of the granting of an undertaking to indemnify in accordance with the Note to an undertaking to indemnify for each Company officer in respect of any liability or expense imposed on him by actions taken in his capacity as a Company officer (including his actions in subsidiaries), is within the limits laid down by the Companies Law. The amount of indemnification is capped at 25% of the Company's share capital as it shall be when the indemnification is granted. The undertaking to indemnify shall apply to a list of types of occurrences which is attached to the Note to an undertaking to indemnify which is attached to the immediate report

concerning the convening of a General Meeting to approve the granting of an indemnification commitment.

It should be noted that in the past, the Company granted indemnity to officers in the following areas:

A. An undertaking to indemnify in respect of the issuance under a prospectus from 1998.

B. An undertaking to indemnify for a draft of the prospectus which was submitted to the Securities Authority in 1999.

C. An undertaking to indemnify for Y2K risks.

D. An undertaking to indemnify in respect of an allotment of shares, in everything relating to the framework agreement from January 13, 2002.

E. An advance undertaking to indemnify for any expense or financial liability which is imposed on an officer following a proceeding filed against him in respect of the Company's prospectus from May 2004.

F. An advance undertaking to indemnify Company officers who served in the Company at the time the undertaking to indemnify was made or who were in office during the seven years preceding that date, for any expense or financial liability imposed on an officer due to a claim by a shareholder who held, at any time during the fours years preceding the date on which the undertaking to indemnify was given, 15% and more of the issued share capital of the Company.

G. An undertaking to indemnify to Company officers who served in the Company at the time an undertaking to indemnify was made or who were in office during the seven years preceding that date, to grant a loan for financing reasonable litigation expenses in a proceeding in which an officer is sued by another person, including a derivative action. The loan will become a grant if a competent court does not impose liability on the officer in a peremptory decision.

H. An undertaking to indemnify to officers that the insurance cover for events covered by an officers' insurance policy, which the Company purchased in July 2003, will be maintained for seven years, provided that the cost of the insurance premium is reasonable.

I. An undertaking to indemnify from April 6, 2005 for financial liability imposed on Company officers for reasonable litigation expenses incurred by them in all matters pertaining directly or indirectly to a sale of State holdings in the Company.

J. An undertaking from May 16, 2005 to indemnify Company offers who were in office during the seven years preceding the date of completion of the sale in the Company.

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Date "Bezeq" The Israel Telecommunication Corp. Limited

Name and title of signatories:

Dov Weissglas, Chairman of the Board

Yacov Gelbard, CEO