

October 31, 2006



"Bezeq" The Israel Telecommunication Corp. Limited

Quarterly Report for the period ending 30.9.06

**Update of Chapter A (Description of Company Operations)
of the Periodic Report for 2005**

**Directors' Report on the State of the Company's Affairs
for the period ended September 30, 2006**

**Condensed Interim Consolidated Financial Statements as at
September 30, 2006**

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

**Update of Chapter A (Description of Company
Operations) of the Periodic Report for 2005**

Update of Chapter A (Description of Company Operations)¹ of the Periodic Report for the Year 2005 ("the Periodic Report") of "Bezeq", the Israel Telecommunication Corp. Ltd. ("the Company")

1 – Description of General Development of the Group's Operations

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

To Section 1.1.5 of the Periodic Report – Mergers and acquisitions

On August 2, 2006, the Company and DBS submitted a notice of merger to the Antitrust Commissioner (the "**Commissioner**") regarding exercise of options for shares in DBS by the Company, which is expected to increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. The Commissioner's approval to increase of the Company's holdings in DBS to over 50% had already been given (under certain conditions) in the past (on January 2, 2005), but that approval had expired a year after the date on which it was given, and therefore, the companies applied for approval of the merger yet again. Further to such, the Antitrust Authority wrote to the Company and to DBS demanding to receive details and information relating to the merger application, and the Company and DBS provided the Authority with the details and information so requested. By consent of the Parties, the date of the Antitrust Commissioner's decision was extended to November 9, 2006.

At the end of July 2006, the Company commenced the process of examining a possible merger of the operations of two wholly owned subsidiaries, BezeqCall Communications Ltd. (which deals in the field of Network End Point ("NEP")), and Bezeq International Ltd. (which deals in the field of internet, international calls and integration solutions for businesses). On October 5, 2006, the Antitrust Commissioner's approval for the merger was granted. Completion of the merger is dependent, *inter alia*, upon assignment of BezeqCall Communications Ltd.'s NEP license to Bezeq International Ltd.

On October 15, 2006, BezeqCall Communications Ltd. executed an agreement for the purchase of all of the operations of Tadiran Telecom Communications Services Israel, Limited Partnership, in consideration for the sum of NIS 93 million (subject to certain adjustments in accordance with the date of closing of the transaction). Closing of the transaction shall be subject to completion of due diligence inspections and to the obtaining of consents, including the consent of the Antitrust Commissioner.

To Section 1.1.6 of the Periodic Report – Sales

Pursuant to the Company's immediate reports of April 10, 2006, and June 22, 2006, regarding evaluation of holdings in Walla! Communications Ltd. via its subsidiary Bezeq International Ltd, the Company gave notice, in an immediate report dated July 19, 2006, that it had ceased negotiations held in this regard.

On April 30, 2006 an agreement was signed between the Company, Malam Systems Ltd. and the Goldnet Communications Services partnership, on the one hand, and the subsidiary Bezeq International Ltd. on the other, in the matter of the acquisition of all the operations of the Goldnet Communication Services partnership by Bezeq International Ltd. in consideration of the sum of NIS 6.8 million, which would be divided between the Company (NIS 5.1 million) and Malam Systems Ltd. (NIS 1.7 million). In this regard see also the update to Section 4.9 hereunder.

With respect to the Company's satellite communications operations (Inmarsat and BezeqSat) – the Company has ceased negotiations with potential purchasers as well and is looking into its continued operations in this area.

¹ The update is in accordance with Regulation 39A of the Securities Regulations (Periodic and immediate reports), 5730-1970, and includes material innovations or changes that took place in the corporation's business in any matter that must be described in the Periodic Report. The update pertains to the numbers of the sections in Chapter 1 (Description of Company Operations) in the Periodic Report of the Company for the year 2005.

To Section 1.4 – Distribution of Dividends

- A. Further to Section 1.4.3 of the Periodic Report, on April 16, 2006, the Company paid its shareholders a cash dividend in a total amount of NIS 1,200,000,193, which constitutes, 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.
- B. On October 30, 2006, the Company distributed to its shareholders a further cash dividend in the total sum of NIS 400,000,064, which constitutes, as at the date of the distribution, NIS 0.1535482 per share and 15.35482% of the issued and paid up capital of the Company.

2 – Fixed-Line Domestic Communications - "Bezeq", the Israeli Telecommunication Corp. Ltd. ("the Company")

To Section 2.1 – General Information regarding the Area of Operations

In the matter of Section 2.1.2 of the Periodic Report on the subject of updating the Company's tariffs –

On July 1, 2006, the Communications Regulations (Telecommunications and Broadcasts) (Payments for Telecommunications Services) 5766-2006 and the Communications Regulations (Telecommunications and Broadcasts) (Calculation of Payments for and Linkage of Telecommunications Services) (Amendment No. 2) 5766-2006 came into force. Under these Regulations, and based on the tariff update formula set out in the Communications Regulations (Telecommunications and Broadcasts) (Calculation for Payments for and Linkage of Telecommunications Services) Regulations 5763-2003, reduction of the Company's supervised tariffs prescribed under section 15(a) of the Communications Law, as of July 1, 2006, amounts to an average rate of approximately 0.36% (not including the reduction of VAT by 1% which came into force on the same date). This reduction is based on a change of approximately 2.4% in the consumer price index, less an average cost of living coefficient at the rate of approximately 2.7%. Likewise, the Communications Regulations (Telecommunications and Broadcasts) (Payments for Interconnect) (Amendment) 5766-2006 were enacted on the same date, providing that the reduction of interconnect tariffs as of July 1, 2006 amounts to a rate of approximately 2% (including the reduction of VAT by 1%).

In this regard, see also Note 1(c)(3) to the Company's Financial Statements for the period ended September 30, 2006.

In the matter of Section 2.1.9 of the Periodic Report on the subject of issuing special general licenses for the provision of fixed-line domestic communication services and the policy for provision of VOB services (broadband access telephony) – see the update to Sections 2.6.1 and 2.6.4 below.

To Section 2.2 – Products and Services

The Ministry of Communications has informed the Company that its position is that the Company should have informed it about the provision of IP – Centrex services, which is a virtual private network service before starting to provide the service, and that therefore the Ministry is considering approval of the provision of the service by the Company and its terms. The Company explained to the Ministry that the service is included in its license. The Company replied to all the Ministry's questions and provided the information it requested. The Ministry sent the Company a report of an investigation that it conducted in this regard, and a letter to the effect that the Company's operations are, *prima facie*, not in accordance with the Communications Regulations nor the License, which amounts to provision of a service without the consent of the Ministry. The Ministry asked for the Company's response to the report. The Company is of the opinion that the Ministry's consent to the service is not required, and shall provide its comments on the report.

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

In the matter of Section 2.2.3 of the Periodic Report – internet access service – the number of the Company's ADSL subscribers as at September 30, 2006, is approximately 867,000 (compared with approximately 800,000 subscribers at the end of 2005).

To Section 2.6 – Competition

As part of the trend towards mergers in the communications field, a merger between Netvision, Barak and GlobeCall has been approved by the Antitrust Commissioner. In addition, according to publications, a transaction under which Internet Zahav purchased 60% of the shares in Golden Lines has also been submitted for approval. On July 30, 2006, the Company applied to the Antitrust Commissioner requesting to state its position prior to the handing down of a decision in the matter of the merger between Internet Zahav and Golden Lines. In this regard, see also updates to sections 4.6.1.1 and 4.6.2.1 below.

To Section 2.6.1 of the Periodic Report – Telephony

- A. As at the date of publication of this report, according to reports in the media, HOT's telephony service numbers over 150,000 customers.

On August 10, 2006 and on September 14, 2006, the Company, via its counsel, wrote to the Minister of Communications requesting the immediate enforcement of fulfillment of HOT's obligations and undertakings under the license, regarding the requirements of structural separation. As at the date of publication of this report, the Ministry's comments have not been received. The Company is considering its steps in this regard.

On October 16, 2006, the Ministry of Communications published a hearing for licensees for the provision of domestic fixed-line services, due to the intention of the Ministries of Communications and Finance to extend the "bill and keep" arrangement by nine months. Under the temporary provisions in which this arrangement was prescribed, the Company and a domestic carrier that is not a designated domestic carrier – at present, only HOT – will not have to make payments to each other for interconnection for domestic fixed-line calls ending on their own networks, and each of them is to bear its own costs. Under the temporary provision, this temporary arrangement was limited to a period of two years commencing on November 25, 2004 (two years after the date of notice of the Minister of Communications regarding commencement of the commercial operation of HOT), or for so long as the difference between the total number of traffic minutes originating on such a domestic fixed-line network (HOT) and ending on the Company's network, and the total number of traffic minutes originating on the Company's network and ending on the network of such domestic carrier as aforesaid is no more than one billion fifty million minutes – whichever is the earlier. The Ministry further gave notice that during the course of the term in which this arrangement is to be extended, the temporary provision set out in the Communications (Telecommunications and Broadcasts) (Royalties) (Temporary Provisions) Law, 5765-2004, to the effect that until the end of the term of the temporary provision, the Company may deduct the sum of the payment for interconnect calculated as per the difference in minutes between the networks, which such domestic carrier (HOT) would have had to pay but for the temporary provision, from the sum of the royalties that the Company is required to pay to the State. Licensees were asked to respond by October 25, 2006. The Company, in its response to the hearing, expressed its objection, *inter alia* claiming that extension of the arrangement harms the Company and its rights in a disproportionate manner, and amounts to an arbitrary act, in addition to a long line of relief granted to HOT despite its rate of recruitment of customers which is greater than HOT's forecasts, according to publications ascribed to HOT. Likewise, the Company noted that the proposed extension is not in compliance with an express clarification provided in this regard to the contenders in the process of privatization of the Company.

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

Bezeq International's trial license has been extended until February 8, 2007. In this regard, see update to section 4.1.2 below. The trial license granted to Golden Lines was extended by half a year (until January 31, 2007).

- C. In the matter of Sections 2.6.1 and 2.6.4 of the Periodic Report on the subject of the issuing of special general licenses for the provision of fixed-line domestic communication services – to the best of the Company's knowledge, such licenses have been issued to GlobeCall Communications Limited Partnership, to Cellcom Fixed-Line Communication Services Limited Partnership and to 012 Telecom Ltd. The subsidiary Bezeq International Ltd. has submitted an application for such a license (see update to Section 4.1.2 below), and the subsidiary

Pelephone Communications Ltd has also submitted an application for a special general license for the provision of fixed-line domestic communications services (see update to Section 3.7 below). Likewise, to the best of the Company's knowledge, "Partner" and "Barak" have also filed an application for a special domestic carrier license.

- D. On March 16, 2006, the Company applied to the Ministry of Communications to conduct a marketing trial of paid VOB (despite its clear position that it is entitled to supply that service under its license), receiving a reply in the negative.
- E. In September 2006, a government resolution was passed on the matter of "increased competition in the field of telephony – virtual carriers and broadband access carriers", under which the Minister of Communications was required to review and formulate policy on the issue of provision of domestic telephony services by way of broadband access over the internet, no later than April 1, 2007. Likewise, it was resolved to require the Director General of the Ministry of Communications and the Commissioner for Budgets at the Ministry of Finance to jointly review the question of the operations of virtual carriers in the field of domestic telephony and to formulate, if necessary, a model for acting to encourage the operations of virtual carriers, by May 1, 2007. In this regard, see also Note 1(C)(5) of the periodic report of the Company for the period ending September 30, 2006.
- F. Further to the provisions of section 2.6.1 of the periodic report regarding the policy for provision of VOD services – on October 25, 2006, the Ministry of Communications held a hearing for the relevant communications operators, in order to complete the process of formulating its policy in this area. According to the Ministry's press release, the hearing is to focus on the structure of the interconnect tariff to be paid to a VOB licensee for completion of a call on a "VOB network". According to the press release, the Ministry of Communications is considering a number of alternatives with regard to the issue under examination: (a) a mutuality arrangement under which the interconnect tariff for completion of a call on the network will be identical to payment of interconnection for completion of a call on the public telecommunications network of a domestic operator; (b) the interconnect tariff for completion of a call on a licensee's network will be dependent upon the proportion of the scope of traffic; (c) a combination of these two alternatives. The Ministry further gave notice that in addition, it would enable supplements to positions submitted in this respect in the past to be brought into the hearing, where necessary, including with regard to the issue of provision of VOB services by companies in the Bezeq Group.

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

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

At the beginning of July 2006, Partner gave notice that it had completed purchase of the transmission operations of Med1 I.C.-1 (1999) Ltd. On August 15, 2006, Partner was granted a special license for provision of transmission and data communications services after having purchased Med1 operations as aforesaid.

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

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

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

new and revised petition to the Antitrust Commissioner. In the Company's opinion, the cellular telephony market constitutes an alternative market to fixed-line telephony, and this fact is reinforced by new and up-to-date data that has accumulated during the period since the appeal was filed in 2001.

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

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

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

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

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

On August 23, 2006, the Ministers of Communications and Finance gave notice 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 recommended that should the plan not be implemented and activated by September 1, 2006, "the communications companies relevant to this issue shall be declared as being in infringement of the Law, with all that that entails". Following this resolution, on August 24, 2006, the Company and Pelephone (together with other cellular companies) submitted petitions to the High Court of Justice for grant of a conditional order against the Government of Israel and the Ministry of Communications. In their petitions, the petitioners claim, *inter alia*, that even though they worked hard to implement the plan, and invested considerable resources in doing so, they are unable to comply with the unrealistic timetables prescribed in the Law for implementation of the plan; and at the same time, according to the petitioners, the Ministry of Communications has not prepared a numbering plan regarding number portability, and has not prescribed the structure for payments to be applied between the entities, as required under the provisions of the Law. The State has submitted its preliminary response to the High Court of Justice, in which it sought

to dismiss the petition *in limine*. In this regard, see also Note 1(C)(6) of the periodic report of the Company for the period ended September 30, 2006.

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

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

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

In the matter of a lack of tariff flexibility – the Ministry of Communications has begun intervening in the marketing campaigns offered by the Company to the public. On April 5, 2006, the Ministry of Communications published a press release addressing the consumer public directly, whereby the legality of the Springtime Campaign that the Company launched a few days previously was being examined. In the Springtime Campaign, customers who buy a telephone and other equipment from the equipment suppliers participating in the campaign are entitled to 200 free call minutes per month for calls made from Bezeq to Bezeq, for a period of one year. The Ministry announced that it is possible that customers who purchase the telephones will not be able to realize the benefit. Previously, the Director General of the Ministry of Communications sent a letter to the Company stating that the campaign was launched without the Ministry's approval. In its reply, the Company noted its fundamental legal position, which was sent to the Ministry and had not yet elicited a response, whereby the Company does not need the Ministry's approval for marketing campaigns. However, without prejudice to this position on the part of the Company, the Company clarified that in any case the campaign in question does not fall under the category of an existing work procedure vis-à-vis the Ministry. After publication of the Ministry's press release, the Company demanded that the Ministry publish a denial or a correction. The Ministry failed to respond and continued to demand information, documents and data. The Company gave the Ministry documents and data, despite its position that the Ministry has no authority in this matter. In addition, the Company announced that it reserves the right to act in this matter. Subsequently, the Ministry of Communications announced its intention to foreclose on a guarantee in the sum of NIS 7 million out of the bank guarantee of \$10 million that the Company deposited to guarantee fulfillment of the terms of its license.

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

With respect to complaints by communications operators to the Ministry of Communications and to the Antitrust Commissioner against the Company, and the Company's responses in this regard, see Note 1(c)(9) to the Company's Financial Statements for the period ending September 30, 2006.

To Section 2.9 – Human Resources

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

In the matter of Section 2.9.5 – negotiations between the Company's management and the employees' representatives regarding the change in the Company's organizational structure, retirement/dismissal of employees, capital reduction, options and shares, and a new labor agreement, are currently being held. The agreement requires the consent of the New General Trade Union and the board of directors of the Company. Regarding collective labor disputes declared on April 27, 2006 and October 5, 2006, see note 6 to the financial statements for the period ending September 30, 2006.

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

For the purpose of fulfilling the duty to implementing number portability between communications licensees, the Company is in various stages of contracting or performing projects with various suppliers which include purchasing new systems and making adjustments to existing systems. These contracts include purchase of new computing and switching systems, and the effecting of changes, adjustments and upgrades to the existing systems used by the Company in order to provide services to its customers, and surrounding systems used by the Company to support those systems.

With respect to section 2.10.2 in the table in the Financial Statements for 2005, which contains details of the Company's purchases in 2005, the ratio of purchases out of total purchases in the field of operations as at September 30, 2006 changed with respect to Amdocs (billing) from approximately 5% to approximately 14%, and with respect to Supplier D (transmission equipment) from approximately 12% to approximately 10% (the maintenance agreement with Supplier D was extended until the end of March 2008) and with respect to Supplier E from approximately 5% to approximately 8%.

To Section 2.13 - Financing

To Section 2.13.2 of the Periodic Report – Restrictions on Receipt of Credit

Following payment of the balance of a long term loan in the sum of approximately NIS 460,000, the Company's liability for restrictions imposed upon it under the agreement for such loan were terminated, including the obligation that it remain in a net financial debt to operating capital before depreciation ratio (EBITDA) of no more than 3:1, with respect to the Group. In this regard, see also Note 5 to the Company's financial statements for the period ending September 30, 2006.

To Section 2.13.5 of the Periodic Report – Variable Interest Loans

The balance of dollar and dollar-linked loans and debentures fell from NIS 564 million (as at December 31, 2005) to NIS 32 million (as at September 30, 2006). Likewise, the Shekel-linked loan and debenture balance fell from NIS 36 million (as at December 31, 2005) to zero (as at September 30, 2006).

To Section 2.13.6 of the Periodic Report – Credit Rating

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

To Section 2.15 – Environmental Protection

In the matter of Section 2.15.2 - the Non-Ionizing Radiation Law, 5766-2006 (the "**New Radiation Law**") – on March 26, 2006 the Radiation Supervisor notified the Company and the cellular operators that for the purpose of readiness for most of the provisions of the New Radiation Law coming into effect on January 1, 2007, and with the goal of tightening and improving supervision, he intends to exercise his authority under the Pharmacists Regulations. He further notified that therefore, as of June 1, 2006, those applying for operating permits would be required to comply with the conditions for issuing a permit, including the condition relating to submission of a permit under the Planning and Construction Law.

In light of the changes expected in this field as a result of entry into force of the New Radiation Law, the Company, *inter alia*, is implementing a series of acts into effect, as follows:

- Survey of its communications and broadcast sites, and inspection of the licensing status of them.

- Speed-up of processes for obtaining construction permits for those sites that, for various, mostly bureaucratic or legal reasons, do not have permits. For the restriction in this regard relating to large broadcasting sites, see update to section 2.16.11 below.
- Settlement of various issues in coordination with the Commissioner for Non-Ionizing Radiation at the Ministry of the Environment.
- Applications to the relevant government ministries (the Ministry of the Interior, the Ministry of the Environment and the Ministry of Communications).
- Notices to various persons who receive communications and broadcasting services from the Company via installations the continued operation of which is suspect in light of the provisions of the New Radiation Law, if the appropriate permits are not obtained.
- Preparation of working procedures with regard to the set-up, operation and measurement of sources of non-ionizing radiation, and an appropriate enforcement procedure.
- Preparation of an enforcement procedure approved by the board of directors of the Company.

See also update to section 3.18.1.3.2 below, and Note 7A(23) to the financial statements of the Company for the period ending September 30, 2006.

To Section 2.16 – Limitations and Regulation of Company Activity

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

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

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

On September 12, 2006, the Company wrote a letter to the Ministry of Communications reminding the Ministry of its application of March 19, 2006 to urgently deal with the grant of relief to the Company in regard to supervision of its activities in areas of operation in which the Company’s market share had fallen to less than 85%. On October 3, 2006, the Ministry replied that it was looking into the application with respect to high-speed internet, and would respond soon.

On September 19, 2006, the Company made an application to the Minister of Communications to perform the provisions of the clarification document to contenders in the process of privatization of the Company dated April 6, 2005, to the effect that the Ministry intended to prescribe two "examination stations", the first in November 2006 and the second in November 2007, at which the possibility of permitting the Company to sell service packages including services provided also by subsidiaries

would be examined even if the Company had not lost a 15% market share. The Company requested that this examination take place as soon as possible. On September 29, 2006, the Ministry replied to the Company that the examination would take place based, *inter alia*, upon details of competitor operations in the field of domestic communications, in the period of up to and including October 2006.

On October 18, 2006, the Ministry of Communications published a hearing for general licensees in the matter of its intention to regulate the issue of a "fixed transaction" by way of amendment to the licenses, under which notices are to be given to customers regarding termination of the obligation period and the tariff to apply thereafter. *Prima facie*, this amendment imposes an operating burden on the Company, and it intends to provide its objections in this regard to the Ministry.

To Section 2.16.3 of the Periodic Report – Royalties

In April 2006 the Company paid the sum that was requested by the Ministry in respect of the Company's revenues from interconnect fees on calls from cellular subscribers to Company subscribers (approximately NIS 17 million). It should be noted that the Company has reached agreements with the Ministry regarding various disputes related to royalties. In this regard, see also Note 7A(9) to the Company's Financial Statements for the period ending September 30, 2006.

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

For the continued possibility of deducting royalties if the "bill and keep" arrangement is extended, see section 2.6.1 above.

To Section 2.16.7 of the Periodic Report – Antitrust Laws

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

In connection with the Antitrust Authority's application in the matter of claims by certain telecommunication operators, see note 1(c)(9) to the financial statements of the Company for the period ended September 30, 2006.

In connection with the search conducted at the Company's offices on May 23, 2006 and the interrogation of a number of Company employees regarding the alleged abuse of the status of the monopoly and/or an unreasonable refusal to supply an asset or service under the monopoly, and for additional searches and the investigation of a number of other employees of the Company (including officers) which took place following this, see note 1(c)(10) to the Company's financial statements for the period ended September 30, 2006.

To Section 2.16.9 – Proposed Legislation regarding Termination of Contractual Relations

On October 25, 2006, the form of the Bill in this regard was brought up for discussion again, without voting taking place on the sections of the Bill. Pursuant to the discussion, a further discussion shall be convened in order to prepare the Bill for reading in the Knesset. The Company has provided its comments to the Committee's general counsel.

In the matter of the hearing for general licensees regarding the intention to regulate a similar issue, the fixed transaction issue, via the licenses, see update to section 2.16.2 above.

To Section 2.16.10 of the Periodic Report – Class Action Suit Law

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

To Section 2.16.11 of the Periodic Report – Erection of Communications Installations – National Outline Plan 36

In the matter of sub-section C, the Company is working with the Ministry of the Interior and the Ministry of the Environment regarding the entry into force of NOP 36B which deals with building permits for large broadcast installations and regarding the requirement in the Radiation Law relating to production of a permit under the Planning and Building Law. In June-July 2006, the Company sent letters to the Ministry of the Interior and to the Ministry of the Environment, requesting that the Law be amended in order that commencement of the provision of the Radiation Law regarding production of a permit under the Planning and Building Law be deferred to three years after the date of entry into force of NOP 36B, and requesting that they act to bring about entry into force of NOP 36B. The Company is acting in this regard with the Ministry of the Environment and the Ministry of the Interior.

See also Note 7A(23) of the financial statements of the Company for the period ended September 30, 2006.

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

On July 24, 2006, a hearing took place in the Knesset Economics Committee on the amended wording of a bill, regarding the provision of services in times of emergency. On September 11, 2006, general licensees were provided with a further amendment of the bill, prior to a discussion which took place in the Knesset Economics Committee. A provision was added to the amendment awarding the Minister of Communications power to give instructions to licensees in the event of a fault or significant termination in the provision of telecommunications services and in the provision of broadcasts, not in emergency circumstances. At the aforesaid discussion in the Knesset Economics Committee, it was alleged that this provision constituted a "new issue", and therefore, the sections of the Bill were not discussed by the Economics Committee. To the best of the Company's knowledge, the Knesset Committee did not remove the new provision from the aforesaid amendment. The Bill, including the new provision, shall be brought up for discussion by the Economic Committee of the Knesset on November 1, 2006. In the Company's position paper regarding the proposed addition, it explained that the provision added is unreasonable and ought not be inserted at all, let alone in this statutory amendment, since stretching the application of provisions dealing with emergencies to matters that relate to the relationship between carriers is not proportionate and is not in compliance with the tests of the Basic Laws. In this regard, see also section 3.18.1.1 below.

To Section 2.16 – Restrictions and Supervision on the Company's Operations in regard to the Government's Decision regarding Proposed Amendments to the Communications Law in the "Budgets Law"

In September 2006, the government decided to affirm a decision by the Ministerial Committee on Society and Economics to amend the Communications Law regarding the imposition of financial sanctions on a licensee, *inter alia* so that the sum of the financial sanction that may be imposed for breach of the provisions of the license or particular provisions under the Communications Law shall be

increased with respect to a licensee whose income in the financial year preceding the breach was more than NIS 100 million, from a sum that is twenty-five times the fine set out in section 61(a)(1) of the Penal Law, 5737-1977 to a sum that is seven times the fine set out in section 61(a)(4) of the Penal Law (approximately NIS 1,400,000), plus 0.25% of the licensee's income during the financial year preceding the date of the breach (the significance of this for the Company is approximately NIS 12,000,000 in 2005 terms, plus 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 by giving full disclosure of information and/or does acts to reduce or stop the breach, up to a 15% reduction on each ground.

Likewise, the government decided to amend section 5 of the Communications Law in such a way as to add a provision to the effect that if the Minister was of the opinion that such were necessary for the purpose of erecting digital radio broadcasting infrastructure under the Second Radio and Television Authority Law, 5750-1990, and that there is no other reasonable alternative enabling the erection of such infrastructure, he may instruct a general licensee that use will be made of the licensee's installations for the purpose of setting up such infrastructure, in return for such payment as may be prescribed.

The Company's position is that in addition to allegations regarding the main point of these proposals, the "Budgets Law" cannot be used as a half-way house for these kinds of amendments, since the provisions in question have serious and substantial consequences, including penal provisions and provisions that harm the Company's property.

On October 23, 2006, the Ministry of Communications' response to the Company's position paper was received, and stated that the new provision added in section 13B of the amended version does not, as the Company claims, open up application or exploit emergency legislation procedures, but rather, is an integral part of the powers of the Minister of Communications in a crisis situation in the field of communications and therefore, the new provision is an integral part of the proposed amendment to section 13 of the Law.

To Section 2.17 – Substantial Agreements

Management Agreement

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

To Section 2.18 – Legal Proceedings

For updates on the subject of legal proceedings, see Note 7 to the financial statements of the Company for the period ended September 30, 2006.

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

To Section 3.2 – Products and Services

In the matter of Section 3.2.2 of the Periodic Report – during the course of 2006, agreements were signed with two GSM carriers to supply roaming services around the world. These agreements enable Pelephone to provide its customers with broader and more varied roaming services.

To Section 3.7 – Competition

In September 2006, the government approved a decision under which the Ministries of Finance and Communications were required to examine the issue of the operation of virtual carriers in Israel in the field of mobile telephony, and to formulate, if necessary, a model for operating to encourage the operations of these virtual companies in Israel by May 1, 2007. A virtual operator (MVNO – Mobile Virtual Network Operator) is a cellular operator that leases airtime from an ordinary cellular operator (which owns infrastructure), by way of a commercial contract with it. The virtual operator makes use of existing cellular networks and sells its services to the public under a separate brand.

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

In the month of August 2006, Pelephone Fixed Line Communications Partnership, which is a limited partnership that is wholly owned by Pelephone and a subsidiary of it, submitted an application for a special general license for the provision of fixed-line domestic telecommunications services.

In the matter of section 3.7.3 of the Periodic Report – on August 23, 2006, the Ministers of Communications and Finance gave notice 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 recommended that should the plan not be implemented and activated by such date, "the communications companies relevant to this issue shall be declared as being in infringement of the Law, with all that that entails". Following this resolution, Pelephone (together with other cellular companies) and Bezeq submitted petitions to the High Court of Justice for grant of a conditional order against the Government of Israel and the Ministry of Communications. In their petitions, the petitioners claim, *inter alia*, that even though they worked hard to implement the plan, and invested considerable resources in doing so, they are unable to comply with the unrealistic timetables prescribed in the Law for implementation of the plan. The petition further alleges that the Ministry of Communications has not prepared a numbering plan regarding number portability, and has not prescribed the structure for payments to be applied between the entities, as required under the provisions of the Law. At this stage, Pelephone is unable to assess the effect of the above. In the State's preliminary response to the petition, the State rejects the claims made in the petition, and holds the communications companies responsible for failure to comply with the regulating provisions of the statute. In this regard, see also update to Section 2.6.5 above.

To Section 3.15 – Financing

In the matter of section 3.15.2.2 of the Periodic Report – In the month of August 2006, Pelephone repaid the loan from the foreign bank and as a result, its obligations regarding restrictions imposed upon it under the loan agreement with it were terminated.

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

In the matter of section 3.18.1.1 –

- A. In September 2006, the Ministerial Committee on Society and Economics approved the Ministry of Communications' proposal to amend the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "**Communications Law**"), in order to be able to increase the fines that the Ministry may impose on the communications companies for

breach of the provisions of the Communications Law. Under the approved proposal, a monetary sanction in 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 licensee's total revenue during the financial year preceding the date of the breach will be imposed upon a licensee whose revenue during the financial year preceding the date of the breach is greater than NIS 100 million. This statutory amendment needs to be legislated in the Knesset.

- B. In September 2006, the Ministry of Communications submitted an expanded proposal to amend the Communications Law (Amendment No. 34) under which the government would be granted special powers during communications crises in situations of national emergency. In a hearing held before the Knesset Economics Committee, and as part of the process of drafting the bill for second reading, a demand was made to extend the application of "communications crisis" to include matters that were not connected to the occurrence of a state of national emergency, to events such as failure by a certain communications carrier to provide communications, causing harm to the entire population or part thereof. Therefore, the Ministry decided to extend the amendment by addition of a new section 13B. Pelephone has expressed its objection to the amendment by addition of the new section 13B, although the Ministry of Communications did not accept its position. On November 1, 2006 the Knesset Economics Committee is expected to again discuss the proposed law.

In the matter of Section 3.18.1.3.2 – during the first quarter of 2006, notification was received from the Radiation Supervisor (the "**Supervisor**") whereby the implementation of some of the requirements of the Non-Ionized Radiation Law, 5766-2006 (the "**Radiation Law**"), among them making the issue of authorizations contingent upon obtaining a building permit, will be brought forward to June 1, 2006. Pelephone informed the Supervisor of its opposition to the date being brought forward, and that the Supervisor should adhere to the effective date determined in the law, i.e. January 1, 2007. In discussions that took place with the Supervisor and the cellular companies, the Supervisor gave notice of his intention to restrict the term of the operations permits given under the Pharmacists Regulations to sites without building permits, up to January 1, 2007. Pelephone claims that this is exercise of power in contravention of the transitional provisions set out in the Radiation Law, to the effect that permits given to sites under the Pharmacists Regulations which were in force immediately prior to entry into force of the Radiation Law shall be deemed for the duration of their term, to be permits given in accordance with the Radiation Law. At the same time, Pelephone is acting to comply with the provisions of the Law as aforesaid. With respect to building permits, as at the date of this Report, approximately 80%² of the sites at which Pelephone operates are authorized. Pelephone is acting to obtain permits and solutions for the rest of the sites.

In this regard, see also Note 7A(23) to the Company's Financial Statements for the period ending September 30, 2006.

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

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

In the matter of Section 3.18.3.1:

- A. The Ministry of Communications recently amended the licenses of the cellular operators in the matter of limiting users' access to the internet in order to obtain services that include adult content. The amendment stipulates, *inter alia*, that access to erotic services included in a cellular portal or by means of an application such as a search engine which is included in a

² This number includes approximately 6% of sites defined as access installations. These installations are exempt from building permits although there are local councils which claim that such a permit is required.

cellular portal and which enables access to sites on the internet, will be blocked for all subscribers by default, and only an adult aged 18 and above will be able to request the removal of the block from his cellular operator, in accordance with a reliable identification procedure. The amendment to the licenses entered into effect on March 30, 2006. At this stage Pelephone does not expect material damage to its revenues as a result of the amendment. "Partner" and "Cellcom" have petitioned the High Court of Justice against this amendment.

- B. The Ministry of Communications is holding a hearing with regard to its intention to require a subscriber whose call is routed to a voicemail box be given the option of disconnecting the call with no charge, by means of a preliminary voice message notifying the subscriber that his call is being transferred to a voicemail box, and that he will be charged only from that time. In response to a hearing in writing, Pelephone expressed its objection to this process. If the Ministry of Communications puts its intention into full effect, this is expected to harm Pelephone's revenues.
- C. In August 2006, the Ministry of Communications wrote to the cellular companies asking for their response to its intention to amend the companies' licenses with respect to severance of the link between a transaction for the purchase of cellular terminal equipment and the grant of benefits. Under the proposed amendment to the license, a licensee shall not create any connection between a transaction to purchase terminal equipment from cellular companies and the grant of a monetary benefit for consumption of airtime, or other benefits. In light of this, the Ministry of Communications is considering severing the link between the sale of terminal equipment by operators and the grant of benefits relating to cellular services. That is so as to ensure that subscribers of cellular companies who purchase terminal equipment from a different cellular operator or from equipment suppliers who are not cellular operators might receive the same conditions, including monetary credit for consumption of airtime, as they would have been entitled to had they purchased the terminal equipment from the cellular company of which they are subscribers. Pelephone has expressed its objection to this amendment to the license. At this stage, Pelephone is unable to assess the effect of this license amendment in the event that it is passed.
- D. In August 2006, the Telecommunications (Royalties) Regulations 5761-2001 were amended so that as of January 1, 2006, the royalty rate is 3% of the revenue upon which royalties are charged. Each year, the royalty rate shall be reduced by 0.5% down to a rate of 1% from 2010 onwards. In this regard, see also update to section 2.16.3 above.

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

With respect to section 3.18.3.3, as at the date of this update, Pelephone has deposited 38 deeds of indemnity with various local councils.

To Section 3.19 – Legal Proceedings

For updates on the subject of legal proceedings, see Note 7 to the financial statements of the Company for the period that ended on September 30, 2006.

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

To Section 4.1 – General

In the matter of Section 4.1.2 – Legislative and Regulatory Restrictions Applicable to Bezeq International – on May 16, 2006 Bezeq International submitted an application for a special general license for the provision of fixed-line domestic communications services to the Ministry of Communications. The issuing of a license, as stated, by virtue of which domestic VOB services will be provided (constituting an essential part of the product mix of internet service providers), will enable Bezeq International to continue to provide its customers with comprehensive communications solutions (of the types that its competitors will offer, some of which have already received similar licenses) and to expand as an equal among equals. Since the Ministry of Communications has not yet replied to Bezeq International's application to receive a general license, on July 25, 2006, Bezeq International submitted an application to extend the term of the trial license to market VoIP services for payment given to it up to August 31, 2006, up to the date of the decision by the Ministry of Communications regarding grant of the general license. On August 31, 2006, the Ministry of Communications gave notice to Bezeq International of extension of the term of the trial license until February 28, 2007.

To Section 4.1.2.2 – Royalties

In August 2006, the Ministries of Communications and Finance approved the Telecommunications (Royalties) (Amendment) Regulations, 5766-2006, under which the royalties rate was reduced from 3.5% to 3%, as of January 2006. Similarly, the amendment prescribes that the rate of royalties shall gradually reduce so that in 2007, it shall be 2.5%; in 2008, 2%; in 2009, 1.5%; and as of January 1, 2010, the rate shall be 1%. In this regard, see also update to section 2.16.3 above.

To Section 4.6.1.1 – Competition in the field of voice

Netvision, Barak and GlobeCall have received the approval of the Antitrust Commissioner for a merger between them. Likewise, according to publications, Internet Zahav has purchased 60% of the shares of Golden Lines, and the companies intend, in the future, to merge. For these matters, see also the update to section 2.6 above.

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

To Section 4.6.2.1 – Competition in the field of internet

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

To Section 4.9 – Intangible Assets

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

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

accepted into various functions at Bezeq International, in accordance with the provisions of the agreement.

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

To Section 4.10 – Human Resources

In the matter of Section 4.10.3 - Organizational Structure - on May 15, 2006, Bezeq International consolidated the Technologies Division and the Information Systems Division into a new division to be called Information Technologies, which shall be headed by, as Vice President, the individual who served as director of the Technologies Division up to that time.

On July 24, 2006, Bezeq International consolidated its business sales department with its integration and new business department, into a new department called "business solutions", at the head of which will be the person who, up until now, acted as Vice President of Integration and New Businesses.

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

To Section 4.14 – Investments

During the report period, Bezeq International and others exercised option warrants of Walla (Series 3). In total, Bezeq International exercised 2,564,764 option warrants (Series 3) during Q1 2006, in consideration of a sum total of NIS 4,617 thousand, which was offset from the owners loan balance that Bezeq International extended to Walla. Following the exercise of the option warrants as stated, Bezeq International's holding in Walla grew from 42.85% on December 31, 2005 to 44.38% as at the date of the interim financial statements (fully diluted, as at September 30, 2006 – 33.66%). Following the exercise of the option warrants, goodwill in the sum of NIS 2,313,000 was generated for the Company.

To Section 4.15 – Financing

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

To Section 4.19 – Legal proceedings

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

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

On July 6, 2006, a preliminary hearing was held in which it was held that the State must submit its response to the appeal by July 27, 2006. In the estimate of Bezeq International, in reliance, *inter alia*, upon its legal counsel, the chances are good that the sum of the sanction will be cancelled or that the amount of the sanction will be reduced.

2. With respect to the claim by a competing international communications operator against the State of Israel for the sum of NIS 11.2 million dated April 4, 2004, under which the State of Israel filed a third party notice against the Company and Bezeq International, set out in section 4.19.2 of the Periodic Report for 2005, on December 5, 2005, the plaintiff submitted affidavits of evidence on its behalf. On April 9, 2006, the State submitted an expert opinion. On May 9, 2006, the Court ruled that given the lack of a factual version at this stage by the State, the Company's and Bezeq International's evidence regarding damage should be adduced on time, however, their evidence regarding liability should only be filed after hearing evidence from the State. On June 13, 2006, a preliminary hearing was held under which the Company and Bezeq International gave notice that they would not be filing an opinion as to damage. The plaintiff and the State also agreed in the hearing that the statement of claim, which another international carrier had filed against the State, the Company, and Bezeq International at the time, would be filed as evidence under agreement. The State also agreed to admit the fact that under the claim by the other international communications carrier, the parties applied to mediation, which ended in an agreement, together with payment by the defendant to the plaintiff. The matter has been set down for the hearing of evidence during the course of November 2006.
3. With respect to the claim submitted against Bezeq International and two other international operators claiming breach of patent for a prepaid telephone system in the sum of NIS 10 million by persons claiming to be the inventors and owners of the aforesaid patent, described in section 4.19.3 of the Periodic Report for 2005, on June 25, 2006, the plaintiffs submitted a response by them. In their response, the plaintiffs claim, *inter alia*, that their claim had not expired and was not tainted by laches, estoppel or injunction, that the patent was valid and belonged to them (and not to the State of Israel – Ministry of Communications), and they repeat their claims regarding breach of the patent by the defendants, and their demand to rule the relief sought under the statement of claim. On the same date, the plaintiffs also submitted an application to expunge claims from the statement of defense, regarding the claim that the plaintiff has no right of standing in this matter, and the claim that the general idea of the patent was conceived within the Ministry of Communications, during the period in which the plaintiff acted as Chief Scientist of the Ministry, and that therefore the plaintiffs are not the real owners of the patent. On September 20, 2006, the Court dismissed the application to expunge claims made in the statement of defense, and on October 4, 2006, the plaintiffs filed an appeal against that decision. On September 10, 2006, an amended statement of defense to the amended third party notice submitted by the defendants on July 30, 2006 was submitted by the supplier of the system the subject of the claim, of which Bezeq International had made use.
4. For additional updates regarding legal proceedings, see Note 7 to the Company's Financial Statements for the period ended September 30, 2006.

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

To Section 5.1 – General Information on Field of Activity

As at September 30, 2006, the number of DBS subscribers amounted to 538,713 subscribers.

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

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

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

Recently, the Prime Minister's Office has been examining the possibility of including the broadcasts of one of the designated channels in with the reduced channel package, in lieu of Channel 33. DBS contacted the Minister of Communications in this regard and expressed its objection to that proposal.

In DBS's assessment, implementation of any of these government decisions could cause harm to DBS's revenues.

To Section 5.6 - Competition

To Section 5.6.5 – Principal Methods for Coping with Competition

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

In the matter of VOD – on May 28, 2006, the Deputy Director General of Economics and Budgets in the Ministry of Communications wrote a letter to DBS informing the latter that following a hearing that had been held, the Ministry, together with the Public Broadcasting Regulation Administration, was examining a number of issues, and that to that end, a ministerial team had been set up. To the best of DBS's knowledge, this team completed its work a while ago, but its conclusions have not yet been published. On September 3, 2006, DBS received a license to conduct a technological trial of provision of VOD services over Bezeq's infrastructure. The duration of the approved trial is one year, and it has been limited to 500 participants.

To Section 5.10 – Raw Materials and Suppliers

To Section 5.10.1 – Main Raw Materials

In the matter of Sub-Section B – space segments – as at the date of this report, DBS is paying the regular leasehold fees in respect of space segments in the Amos 1 satellite, and remits partial payment on account of the leasehold fee debt in respect of the previous period whose date of payment to Israel Aircraft Industries has passed (in view of the endorsement of the right to receive the leasehold fees from HLL to Israel Aircraft Industries). In view of DBS's delay in payments that were

stipulated in the said agreement, Israel Aircraft Industries contacted DBS in March 2006 demanding that the entire debt be settled, and the parties are conducting negotiations on the matter. In addition, there is a dispute between DBS and HLL in the matter of the annual leasehold fees that HLL is entitled to receive in respect of the leasing of space segments in the Amos 2 satellite, which has not yet been arranged, with DBS paying only those sums that are not in dispute.

To Section 5.11 – Working Capital

In Q3 2006 an increase occurred in the working capital deficit of DBS, which totaled approximately NIS 581 million as at September 30, 2006.

To Section 5.12 - Financing

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

As at September 30, 2006 DBS met the financial criteria, as per the financing agreement (after the banks agreed to amend the targets of these criteria with regard to the first three quarters of 2006). In the estimation of the management of DBS, in view of its forecasts with regard to its business results for the years ahead, it is also necessary to adjust the criteria with regard to the period up to the end of the repayment of the bank credit. In consequence, in July 2006 DBS contacted the banks requesting, *inter alia*, an amendment of the relevant provisions of the financing agreement relating to targets for financial criteria. In this regard, see Note 4A to the Company's financial statements for the period ended September 30, 2006.

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

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

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

To Section 5.14 – Restrictions and Supervision of the Corporation

To Section 5.14.1 – Specific legal restrictions on operations

On the subject of original (local) productions - DBS has met its obligation for the year 2004 (including the relative share of completing past obligations), apart from immaterial deviations in the subdivision into the various genres, which the Council ordered DBS to amend during 2005. In the month of September 2006, the council affirmed that DBS had met its original productions obligation for the year 2005 (including the relative share of completing past obligations) with the exception of insubstantial deviations in the sub-division into various issues.

In the month of August, 2006, the Communications (Telecommunications and Broadcasts) (Satellite Television Broadcasts) (License Fees and Royalties) Regulations, 5759-1999 were amended to the effect that the rate of royalties applicable to DBS will be gradually reduced from a rate of 3% in 2006 to a fixed percentage of 1% from 2010 onwards.

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

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

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

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

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

To Section 5.17 – Legal Proceedings

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

In the matter of Section 5.17.2 – the lawsuit in the Trojan Horse matter – on September 18, 2005, the Company's response was submitted, in which it applied for dismissal of the application. On September 5, 2006, the Court handed down a ruling instructing the plaintiff to give notice of whether it was going to insist on its application to split remedies. On September 26, 2006, notice was filed with the Court on behalf of the plaintiffs in which they stated that they were insisting on their application. No ruling has yet to be handed down in the application. No date has yet to be set down for hearing the claim. The first pre-trial session in the matter has been set down for May 21, 2007.

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

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

In addition:

1. on March 15, 2006 a verdict was handed down against DBS and Mr. Shlomo Liran, its former CEO, following DBS's conviction at the Tel Aviv District Labor Court of the offense of disturbing a work supervisor on behalf of the Ministry of Labor and Social Welfare – an offense under Section 26(2) of the Hours of Work and Rest Law, 5711 – 1951 and Sections 36(A)(1) and 36(C) of the Organization of Supervision of Labor Law, 5714 – 1954, and with regard to Mr.

Liran, also under Section 27(A) of the Hours of Work and Rest Law, 5711 – 1951 and Section 36(E) of the Organization of Supervision of Labor Law, 5714 – 1954. DBS's conviction was based on the failure to submit documents to a work supervisor, on demand, in contravention of the obligations stipulated by law. The District Court imposed an administrative fine in the sum of NIS 25,800 on DBS and an administrative fine in the sum of NIS 38,700 on Mr. Liran. In May 2006, DBS and Mr. Shlomo Liran appealed to the National Labor Court against their conviction. The appeal was set down for hearing before a panel on December 4, 2006.

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

On October 16, 2006, the defendant applied to require DBS to deposit a bank guarantee in the sum of no less than NIS 1.5 million, plus VAT, in assurance of the defendant's expenses, and applied, *ex parte*, to extend the date of submission of a statement of defense and/or application to cancel the permit for service granted to DBS to a date 30 days after the date of receipt of a decision on the application to deposit a guarantee.

DBS's response to the application has not yet been filed and rulings in the applications have not yet been made.

For additional updates regarding legal proceedings, see Note 7 to the Company's financial statements for the period ending September 30, 2006.

October 31, 2006

Date

"Bezeq", The Israel Telecommunication Corp. Ltd.

Name and title of signatories:

Dov Weissglas, Chairman of the Board

Yacov Gelbard, President & CEO

**Directors' Report on the State of the Company's
Affairs for the period ended September 30, 2006**

Directors' Report on the State of the Company's Affairs
for the nine months ended September 30, 2006

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited ("the Company") and the consolidated Group companies (the Company and the consolidated companies are hereinafter collectively referred to as "the Group") for the nine-month period ended September 30, 2006 ("the Directors' Report").

The Directors' Report contains a review of its subject matter, in condensed form, and was prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2005.

The Group operates in four principal areas which are reported as business segments in the Company's consolidated reports, as follows:

- 1) **Fixed-line domestic communications**
- 2) **Cellular**
- 3) **International communications and internet services**
- 4) **Multi-channel television**

The Company has other areas of operation which are not material to the operations of the Group, and these are included in the financial statements as at September 30, 2006 of the Company as the "Others" business segment, which consists mainly of network end point services and customer center services.

1. Financial Position

- A. The Group's assets as at September 30, 2006, amounted to approximately NIS 18.54 billion, compared with NIS 20.65 billion on September 30, 2005. Of these, approximately NIS 8.96 billion (approximately 48%) are fixed assets, compared with approximately NIS 10.12 billion (approximately 49%) on September 30, 2005.

The reduction stemmed mainly from the fixed-line domestic communications segment. In this segment, there was a decrease in total assets compared with the previous year, in the amount of approximately NIS 1.1 billion, mainly due to a decrease in the net book value of the fixed assets resulting from the difference between depreciation expenses and the investment made in the reporting period. In addition, there was a decrease in long-term investments and cash balances, which has been moderated by an increase in short-term investments.

In the cellular segment, assets decreased from approximately NIS 5.6 billion as at September 30, 2005, to approximately NIS 4.9 billion as at September 30, 2006. This reduction stemmed mainly from utilizing deposits and short-term investments applied in distribution of a dividend and repayment of loans, and from a reduction in the depreciated cost of fixed assets. In addition, there was a decrease in the inventory balance as a result of a decrease in inventory costs and quantities, and a decrease in the deferred tax balance due to utilization of past losses for tax purposes.

In the international communications and internet services segment there was a decrease in total assets compared with September 30, 2005, mainly due to a decrease in cash balances and the net investment in fixed assets.

In the multi-channel television segment total assets decreased compared with September 30, 2005, which derived mainly from a decrease in the net investment in fixed assets. The decrease was moderated by an increase in the broadcasting rights and the trade receivables balance.

- B. Shareholders' equity as at September 30, 2006, amounted to approximately NIS 7.41 billion, representing approximately 40% of the total balance sheet, compared with approximately NIS 7.87 billion on September 30, 2005, which represented approximately 38% of the total balance sheet. The decrease in shareholders' equity derived from the distribution of a dividend of NIS 1.2 billion during the reporting period. The decrease was moderated by the net earnings of the Group.

Shareholders' equity as at September 30, 2005, was retroactively adjusted by restatement following recording of the Company's undertaking to its retirees (see Note 2D to the Financial Statements).

- C. Total Group debt to financial institutions and debenture holders as at September 30, 2006 amounted to approximately NIS 7.60 billion, compared with approximately NIS 9.08 billion on September 30, 2005. The decrease derived mainly from a decrease in liabilities in the cellular segment and in the domestic fixed-line communications segment. The decrease was partially offset as a result of an increase in liabilities in the multi-channel television segment.

The Company's auditors drew attention to the financial condition of DBS, as mentioned in note 4(A), including DBS management's estimation, based on its updated forecasts and on its alternative business plan, that the prospects are good for arranging the financial resources it will need in the coming year.

- D. Group balances in cash and short-term investments as at September 30, 2006, amounted to approximately NIS 3.52 billion compared with approximately NIS 4.16 billion on September 30, 2005. The decrease derived from the dividend in the amount of NIS 1.2 billion distributed in the reporting period. In addition, in the cellular segment, deposits and investments in securities were utilized in order to repay loans. The decrease was set off due to cash flow from current operations in the principal sectors in which the Company operates.

2. Results of Operations

A. Principal results

Net earnings for the first nine months of 2006 amounted to approximately NIS 701 million, compared with net earnings of approximately NIS 547 million in the corresponding period in 2005. The increase in the net earnings derived mainly from an increase in operating income of the Group companies, set off by a decrease in other net revenues. Earnings after financing expenses amounted to approximately NIS 1,042 million compared to NIS 781 million in the corresponding period.

Below are details of the changes in the results of the segments this year as compared with the same period last year.

| <u>Segment</u> | For the nine-month period ended September 30 | |
|--|---|-----------------------------|
| | 2006 | 2005 |
| | <u>NIS millions</u> | <u>NIS millions</u> |
| | <u>Income (loss)</u> | <u>Income (loss)</u> |
| Fixed-line domestic communications | 765 | 681 |
| Cellular | 458 | 384 |
| International communications and internet services | 102 | 69 |
| Multi-channel television | (36) | (79) |
| Others | 9 | (2) |

Earnings per share in the first nine months of 2006 amounted to NIS 0.269 per NIS 1 par value share, compared with earnings of NIS 0.210 per share in the corresponding period.

B. Revenues

Group revenues in the first nine months of 2006 amounted to approximately NIS 8.53 billion, compared with approximately NIS 8.34 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 3.57 billion in the first nine months of 2005 to approximately NIS 3.51 billion in the first nine months of 2006 (a decrease of approximately 1.6%). Most of the decrease in the segment's revenues derived from tariff reductions in June 2005 and July 2006, a decrease in call traffic and in development work. The decrease in revenues was moderated by the ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). In their review letter, the auditors drew attention to the ongoing opening of the communications industry to competition and to tariff changes.

Revenues from the cellular segment decreased from approximately NIS 3.35 billion in the first nine months of 2005 to approximately NIS 3.33 billion in the reporting period, resulting from a decrease in revenues from the sale of terminal equipment due to a decrease in the amount of handsets sold and updated, and a decrease in the prices of such handsets. Conversely, revenues from cellular services increased due to an increase in the number of customers and an increase in content revenues, less the effect of a decrease in interconnect tariffs.

Revenues from the international communications and internet services segment increased from approximately NIS 604 million in the first nine months of 2005 to approximately NIS 761 million in the reporting period. The increase was due mainly to an increase in all areas and an increase in the global operations, except for a decrease in revenues from outgoing calls as traffic continues to decline and tariffs are eroded due to the expansion of competition.

Revenues from the multi-channel television segment increased from approximately NIS 896 million in the first nine months of 2005, to approximately NIS 1,009 million in the reporting period, as a result of the increase in the number of subscribers and in average revenue per customer.

C. General and Operating Expenses

The Group's general and operating expenses in the first nine months of 2006 amounted to approximately NIS 5.4 billion, compared with approximately NIS 5.3 billion in the corresponding period.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 1,733 million in the first nine months of 2005, to approximately NIS 1,744 million in the reporting period. Most of the increase is attributable to the increase in salary and vehicle maintenance expenses, and were set off mainly by a decrease in general expenses (mainly advertising) and in expenses for services and maintenance by sub-contractors.

In the cellular segment, general and operating expenses decreased from approximately NIS 2,506 million in the first nine months of 2005, to approximately NIS 2,368 million in the reporting period, mainly due to lower costs of terminal equipment in parallel with a decrease in revenues from the sale of terminal equipment, a decrease in the cost of spare parts and laboratory repairs and a reduction in expenses for salaries, doubtful debts and distribution fees. The decrease was set off in part by an increase in the cost of call completion fees, content operation expenses and advertising and sales promotion costs.

In the international communications and internet services segment, general and operating expenses increased from approximately NIS 460 million in the first nine months of 2005, to approximately NIS 595 million in the reporting period. The increase derived mainly from the increase in global operations with a corresponding increase in revenues, and also from an increase in expenses attributed to internet customers, and customer recruitment expenses.

The general and operating expenses of the multi-channel television segment increased from approximately NIS 733 million in the first nine months of 2005, to approximately NIS 793 million in the reporting period, as a result of an increase in content expenses and lease fees for satellite segments.

D. Depreciation

The Group's depreciation expenses decreased from approximately NIS 1,749 million in the first nine months of 2005, to approximately NIS 1,708 million in the reporting period, due to the cessation of depreciation of fully depreciated fixed assets and a lower level of investment in new assets in the fixed-line domestic communications segment and in the international communications and internet services segment. The decrease was offset by an increase in depreciation expenses in the cellular segment due to the accelerated depreciation expenses of sites designated for dismantling as well as an increase in the multi-channel television segment.

E. Royalties to the Government of Israel

The Group's royalties expense amounted to approximately NIS 126 million, compared with approximately NIS 195 million in the corresponding period, mainly due to a reduction in the rate of royalties by 0.5% as of January 1, 2006 (see Note 1C(1) to the financial statements), a decrease in the provision for royalties in the fixed-line domestic communications segment resulting from an agreement with the Ministry of Communications to end the past dispute up to and including 2002 (see Note 7A(8) to the financial statements), as well as a deduction of the payment for interconnect fees.

F. Operating income

The Group's operating income in the first nine months of 2006 amounted to approximately NIS 1,298 million, compared with approximately NIS 1,053 million in the corresponding period, an increase of approximately NIS 245 million. The increase in operating income derives from the changes in the results of the segments described above in the revenue and expense items. These changes led to an increase in the profitability of the fixed line domestic communications segment, the cellular segment and international and internet services segment, and to improved operating results in the multi-channel television segment.

G. Financing expenses

The Group's net financing expenses in the first nine months of 2006 amounted to approximately NIS 257 million, compared with approximately NIS 272 million in the corresponding period, a decrease of approximately NIS 15 million.

The decrease originates in a reduction in financing costs in the mobile radio telephone sector, stemming from an erosion of CPI-linked loans and a reduction in the status of loans in the sector. The reduction was set off by an increase in financing costs in the multi-channel television sector.

In the domestic fixed line communications sector, financing expenses were similar to the corresponding period mainly due to a decrease in income from capital markets which was offset by cancellation of a provision relating to an agreement with the Ministry of Communications to end past disputes (see Note 7A(8) to the financial statements).

H. Other income

Other income, net in the first nine months of 2006 amounted to approximately NIS 54 million compared with income of approximately NIS 131 million in the corresponding quarter.

The income in the corresponding period derived mainly from capital gains of approximately NIS 104 million and a reduction in the provision for early retirement, in the sum of NIS 83 million (due to transition to an insurance company), which was partially offset by an expense of approximately NIS 70 million in amortization of goodwill in respect of companies then consolidated for the first time in the financial statements (see Note 11 to the financial statements). Income in this period stemmed mainly from capital gains and a dividend received from a venture capital fund. Following publication of Accounting Standard 20 (Amended), effective from the current reporting period, standard amortization of goodwill was terminated.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in the first nine months of 2006 amounted to approximately NIS 2,304 million, compared with approximately NIS 1,802 million in the corresponding period, an increase of approximately NIS 502 million. The source of the increase in cash flow was mainly due to an increase in operating profit, revenues and expenses not involving cash flows and changes in asset and liability items. The changes above were mainly in the cellular segment.

Cash flows generated by operating activities are the principal source of financing of the Group's investments. During the reporting period cash flows from investing activities amounted to NIS 729 million compared with NIS 1,893 million in the corresponding period. The difference was mainly due to investments for the development of telecommunications infrastructures and short-term investments. In the Reporting Period, the Group invested approximately NIS 805 million for the development of telecommunications infrastructures and utilized approximately NIS 100 million of short-term investments, as compared with approximately NIS 1,331 million and NIS 717 million respectively, in the corresponding period.

During the reporting period, the Group repaid approximately NIS 1,410 million of debt, of which approximately NIS 1,175 million was on account of long-term loans and approximately NIS 236 million on account of debentures. In the reporting period the Group raised new debt in a total amount of approximately NIS 65 million by receipt of short-term bank credit. The net amount of debt repaid during the reporting period amounted to NIS 1,345 million, compared with the raising of new debt in the amount of NIS 725 million during the corresponding period. On April 16, 2006 a dividend in the amount of NIS 1,200 million was distributed (see Note 1.C (7) to the financial statements).

The average monthly short-term credit during the first nine months of 2006 was approximately NIS 131 million. The average of monthly long-term liabilities in the first half of 2006 was approximately NIS 8,154 million.

Working capital as at September 30, 2006, was positive and amounted to approximately NIS 655 million, compared to positive working capital on September 30, 2005 of NIS 1,774 million. The decrease was due to a reduction in working capital of all of the principal companies in the Group. The decrease stems mainly from the domestic fixed-line communications sector, due to an increase in current maturities of debentures and a decrease in cash and cash equivalents due to the dividend distribution.

4. Comparison of results of Third Quarter 2006 with results of corresponding quarter

| <u>Segment</u> | For the period of three months ending September 30 | |
|--|---|---|
| | 2006 | 2005 |
| | <u>NIS Millions</u> <u>Income (loss)</u> | <u>NIS Millions</u> <u>Income (loss)</u> |
| Fixed-line domestic communications | 270 | 225 |
| Cellular | 164 | 130 |
| International communications and internet services | 33 | 26 |
| Multi-channel television | (18) | (29) |
| Other | 3 | (2) |

Revenues in the third quarter of 2006 increased by approximately NIS 43 million as compared with the corresponding quarter.

General and operating expenses decreased by approximately NIS 5 million as compared with the corresponding quarter.

Royalty expenses decreased by approximately NIS 29 million as compared with the corresponding quarter, mainly due to a reduction in the rate of royalties (see Note 1C(1) to the financial statements).

In the corresponding quarter, tax expense of approximately NIS 45 million was recorded due to the change in tax rates and their effect on the Group's deferred tax asset. This increased the effective tax rate on the Group's earnings in the corresponding quarter as compared with the reporting period.

Other income, net increased by approximately NIS 45 million as compared to the corresponding quarter – see Note 11 to the financial statements.

The behavior of revenue and expense items and the causes of the differences between the quarters are similar to the explanations in the results of the period. The changes described above in the profit and loss items brought about a net profit of approximately NIS 245 million in the third quarter, compared with a net profit of approximately NIS 103 million in the corresponding quarter.

5. Group involvement in the community and donations

The Group involves itself in community institutions and social organizations such as the education system in distressed areas and border areas, and additionally, employees volunteer in various community activities.

For example, about 500 Group employees held "Exposure to Modern Communications" workshops, in cooperation with the Ministry of Education, for junior high school students.

During the course of hostilities in the north of the country, the companies in the Group volunteered for a variety of activities for residents of the north, including, *inter alia*, connecting bomb shelters to the internet and to satellite television, free calls, renovation of bomb shelters and equipping them and providing service under fire to civilians and soldiers. In addition, employees made donations and distributed food, games and gifts to residents.

In the reporting period, Bezeq donated approximately NIS 1.4 million to community institutions and organizations, the main ones being set out below:

In a project entitled "Children and Parents Learn Computers and Internet", which has been in operation for about five years, Company employees tutor parents and children from disadvantaged groups on various aspects of computers and the internet. The cost of the project, in addition to the volunteer employees' time, is approximately NIS 250 thousand per year.

Under a joint decision between management and the employee organization, Passover *Haggadot* were distributed to employees, which contained drawings by autistic children. The cost of the *Haggadot*, at approximately NIS 73,000, was donated to the Association for Children at High Risk.

In the "Summer for the Community" project, implemented by the Company for the third year running, children of employees, aged 16-18, worked over the summer in medical institutions and community centers. The cost to the Company of this project was approximately NIS 1 million.

Pelephone does not have a binding policy on donations, and its management discusses each case on its merits. In the reporting period, Pelephone donated approximately NIS 121,000 to various causes.

Bezeq International is involved in ongoing activities for disadvantaged populations in Petach Tikva, the "adoption" of soldiers without families in Israel and the adoption of a fighting battalion, and also participates in environmental and educational projects. In the reporting period, Bezeq International donations amounted to approximately NIS 375,000.

6. Details concerning market risk exposure and management thereof

The person responsible for management of market risks at the Company from August 28, 2006 is the Acting CFO, Mr. Shay Ben-Yakar, who is also serving as Head of the Finance & Investments Department since 2004. For three years (2001-2004) he served as the CEO of DS Mutual Funds Management in DS Investment Management. Mr. Ben-Yakar has an MBA in finance.

- A. Further to the description in the Directors' Report for 2005, hedging transactions against market risks relating to exposure to changes in exchange rates substantially reduced such exposure.
- B. The report of positions in derivatives as at September 30, 2006, is not significantly different from the report as at December 31, 2005 (see Note 7B to the financial statements).
- C. The report on linkage bases as at September 30, 2006, is not significantly different from the report as at December 31, 2005.

Surplus liabilities over monetary assets denominated in or linked to a foreign currency as at September 30, 2006, amounted to approximately NIS 1.9 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at September 30, 2006, amounted to approximately NIS 90 million.

Surplus liabilities over monetary assets linked to the CPI as at September 30, 2006 amounted to approximately NIS 3.6 billion in the Group.

In the main segments of the Group, exposure to the Index is reduced since the computation of tax expenses is calculated based on real earnings.

7. Miscellaneous

Peer review

The Company has expressed its agreement to transfer the material required for a sampling relating to a peer review, following the directive of the Securities Authority published on July 20, 2005. This consent is subject to the maintaining of the confidentiality of the data transferred, as well as guaranteeing prevention of conflict of interests of the reviewers.

We thank the managers and employees of the Group companies, and our shareholders.

Dov Weissglas
Chairman of the Board

Yacov Gelbard
President & CEO

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2006

Condensed Interim Consolidated Financial Statements as at September 30, 2006 (unaudited)

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**The Board of Directors of
"Bezeq" - The Israel Telecommunication Corp. Limited**

Dear Sirs,

**Re: Review of the Unaudited Condensed Interim Consolidated Financial
Statements as at September 30, 2006**

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter "Company") as at September 30, 2006, as well as the condensed interim consolidated statements of operations, the condensed interim statements of changes in shareholders' equity and the condensed interim consolidated statements of cash flows for the nine-month period then ended.

Our review was carried out in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel. The procedures included, inter alia, reading the said financial statements, reading the minutes of meetings of the shareholders and of the Board of Directors and its committees, as well as making inquiries of persons responsible for financial and accounting matters.

Reports of other auditors were furnished to us which relate to the review of the condensed interim financial statements of consolidated subsidiaries, whose assets as at September 30, 2006, constitute approximately 7% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 12% of the total revenues included in the condensed interim consolidated statement of operations for the nine-month period then ended and approximately 11% of the total revenues included in the condensed interim consolidated statement of operations for the three-month period then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in which the Company's investments amount to approximately NIS 95 million as at September 30, 2006, and the Company's share in the losses in respect thereof amount to approximately NIS 2,790 thousand and NIS 1,167 thousand for the nine-month and three-month periods then ended.

As the review is limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the interim consolidated financial statements.

Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is the Israeli member firm of KPMG International, a Swiss cooperative.

In the course of our review, including reviewing the reports of other auditors as mentioned above, nothing came to our attention which would indicate the necessity of making material changes to the said interim financial statements in order for them to be in conformity with generally accepted accounting principles and in accordance with the provisions of Section 4 of the Securities Regulations (Periodic and Immediate Reports), 5730-1970.

We draw attention to the uncertainties relating to the following matters, for which the maximum possible exposure is significant:

1. The continuing opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for early retirement as described in Note 6.
3. Contingent claims made against the Company and against invested companies, as described in Note 7A.
4. The financial position of a subsidiary as described in Note 4A, including the opinion of the management of the consolidated company, based on updated forecasts and on the alternative business plan, that the prospects of arranging sources of finance required by the consolidated company in the forthcoming year are good.

Similarly, we draw attention to Note 2D. to the financial statements regarding the adjustment by way of restatement of the financial statements as at September 30, 2005 in order to retroactively reflect the amended treatment of the liability of the Company to its retirees, as described in the abovementioned note.

Somekh Chaikin
Certified Public Accountants (Isr.)

October 31, 2006

Condensed Interim Consolidated Balance Sheets as at

Reported amounts

| | September 30 2006 | September 30 2005 | December 31 2005 |
|--|----------------------|----------------------|---------------------|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | | | |
| Cash and cash equivalents | 1,188,480 | 2,090,898 | 2,158,773 |
| Short-term investments | 2,332,791 | 2,067,668 | 2,398,525 |
| Trade receivables | 2,113,488 | 2,139,566 | 2,113,512 |
| Other receivables and debit balances | 322,355 | 305,185 | 321,507 |
| Inventory | 178,077 | 256,685 | 220,404 |
| | 6,135,191 | 6,860,002 | 7,212,721 |
| Materials and spare parts | 93,040 | 122,269 | 88,881 |
| Broadcasting rights, net | 177,920 | 161,335 | 154,500 |
| Investments and long-term receivables | | | |
| Investments, deposits and debit balances | 684,256 | 858,224 | 766,840 |
| Investments in investee companies | 95,237 | 64,795 | 75,467 |
| | 779,493 | 923,019 | 842,307 |
| Fixed assets | | | |
| Cost | 31,226,773 | 34,606,992 | 30,627,629 |
| Less– accumulated depreciation | 22,269,240 | 24,486,246 | 20,684,981 |
| | 8,957,533 | 10,120,746 | 9,942,648 |
| Other assets | | | |
| Goodwill | 1,693,685 | 1,722,820 | 1,699,546 |
| Deferred charges and other assets | 389,539 | 390,807 | 380,483 |
| Deferred taxes | 311,708 | 349,420 | 344,786 |
| | 2,394,932 | 2,463,047 | 2,424,815 |
| | 18,538,109 | 20,650,418 | 20,665,872 |

| | September 30 2006 | September 30 2005 | December 31 2005 |
|--|------------------------------|------------------------------|-----------------------------|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current liabilities | | | |
| Bank credit | 140,685 | 124,864 | 75,191 |
| Current maturities of: | | | |
| Long-term bank loans | 364,194 | 1,322,361 | 1,262,583 |
| Debentures | 1,985,313 | 553,138 | 527,167 |
| Trade payables | 1,161,858 | 1,259,006 | 1,400,714 |
| Employee severance benefits | 433,656 | 489,066* | 577,878 |
| Other current liabilities | 1,394,670 | 1,337,273 | 1,387,955 |
| | 5,480,376 | 5,085,708 | 5,231,488 |
| Long-term liabilities | | | |
| Long-term loans | 1,907,489 | 2,176,640 | 2,151,960 |
| Debentures | 3,226,121 | 4,902,956 | 4,903,056 |
| Employee severance benefits | 384,506 | 582,206* | 431,427 |
| Deferred taxes | 87,471 | – | – |
| Other long-term liabilities | 37,718 | 33,982 | 34,081 |
| Loans extended by minority in a subsidiary: | | | |
| Loans | 1,139,900 | 1,102,949 | 1,114,498 |
| Less – minority share in deficit of a consolidated company | (1,139,900) | (1,102,949) | (1,114,498) |
| | 5,643,305 | 7,695,784 | 7,520,524 |
| Contingent liabilities (Note 7) | | | |
| Shareholders' equity | 7,414,428 | 7,868,926* | 7,913,860 |
| | 18,538,109 | 20,650,418 | 20,665,872 |

* Restated, see Note 2D

Dov Weissglas
Chairman of the Board

Yacov Gelbard
Chief Executive Officer

Shay Ben Yakar
Acting CFO

Date of approval of the financial statements: October 31, 2006.

The notes to the interim financial statements are an integral part thereof.

Condensed Interim Consolidated Statements of Operations

Reported amounts

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|--|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues (Note 9) | 8,526,531 | 8,339,217 | 2,881,404 | 2,838,719 | 11,098,686 |
| Costs and expenses | | | | | |
| Operating and general expenses (Note 10) | 5,394,748 | 5,341,136 | 1,830,474 | 1,835,484 | 7,193,468 |
| Depreciation | 1,707,582 | 1,749,207 | 563,089 | 587,890 | 2,330,711 |
| Royalties to the Government of Israel | 125,741 | 195,490 | 36,319 | 65,319 | 257,429 |
| | 7,228,071 | 7,285,833 | 2,429,882 | 2,488,693 | 9,781,608 |
| Operating income | 1,298,460 | 1,053,384 | 451,522 | 350,026 | 1,317,078 |
| Financing expenses, net | 256,614 | 272,449 | 70,376 | 107,370 | 417,309 |
| Earnings after financing expenses | 1,041,846 | 780,935 | 381,146 | 242,656 | 899,769 |
| Other income (expenses), net (Note 11) | 54,055 | 130,654 | 23,005 | (22,088) | 109,386 |
| Earnings before income tax | 1,095,901 | 911,589 | 404,151 | 220,568 | 1,009,155 |
| Income tax | 399,042 | 375,294 | 161,273 | 115,471 | 429,594 |
| Earnings after income tax | 696,859 | 536,295 | 242,878 | 105,097 | 579,561 |
| Equity in losses of affiliates | 3,735 | (13,107) | 2,112 | (1,940) | (12,645) |
| Minority share in losses (earnings) of subsidiaries | (26) | 8,971 | - | (8) | 8,942 |
| Earnings before the cumulative effect of a change in accounting principle | 700,568 | 532,159 | 244,990 | 103,149 | 575,858 |
| Cumulative effect of a change in accounting principle as at the beginning of the period | - | 15,000 | - | - | 15,000 |
| Net earnings | 700,568 | 547,159 | 244,990 | 103,149 | 590,858 |
| Primary and diluted earnings per share (in NIS): | | | | | |
| Earnings before the cumulative effect of a change in accounting principle | 0.269 | 0.205 | 0.094 | 0.039 | 0.222 |
| Cumulative effect of a change in accounting principle | - | 0.005 | - | - | 0.005 |
| Net earnings per share | 0.269 | 0.210 | 0.094 | 0.039 | 0.227 |

The notes to the interim financial statements are an integral part thereof.

Condensed Interim Statements of Changes in Shareholders' Equity

Reported amounts

| | Share capital | Capital reserve – share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Dividend proposed after the balance sheet date | Retained earnings (deficit) | Total |
|---|------------------|---------------------------------|--|--|-----------------------------|--------------------|
| NIS thousands | | | | | | |
| Nine months ended September 30, 2006 | | | | | | |
| Balance as at December 31, 2005 (audited) | 6,309,133 | 1,623,423 | 39,010 | 1,200,000 | (1,257,706) | 7,913,860 |
| Net earnings (unaudited) | – | – | – | – | 700,568 | 700,568 |
| Dividend (unaudited) | – | – | – | (1,200,000) | – | (1,200,000) |
| Dividend proposed for payment (unaudited) | – | – | – | 400,000 | (400,000) | – |
| Balance as at September 30, 2006 (unaudited) | <u>6,309,133</u> | <u>1,623,423</u> | <u>39,010</u> | <u>400,000</u> | <u>(957,138)</u> | <u>7,414,428</u> |
| Nine months ended September 30, 2005 | | | | | | |
| Balance as at December 31, 2004 (audited) | 6,309,133 | 1,623,423 | 37,775 | – | (648,564)* | 7,321,767 * |
| Net earnings (unaudited) | – | – | – | – | 547,159 | 547,159 |
| Balance as at September 30, 2005 (unaudited) | <u>6,309,133</u> | <u>1,623,423</u> | <u>37,775</u> | <u>–</u> | <u>(101,405)*</u> | <u>7,868,926 *</u> |
| Three months ended September 30, 2006 | | | | | | |
| Balance as at July 1, 2006 (unaudited) | 6,309,133 | 1,623,423 | 39,010 | – | (802,128) | 7,169,438 |
| Net earnings (unaudited) | – | – | – | – | 244,990 | 244,990 |
| Dividend proposed for payment (unaudited) | – | – | – | 400,000 | (400,000) | – |
| Balance as at September 30, 2006 (unaudited) | <u>6,309,133</u> | <u>1,623,423</u> | <u>39,010</u> | <u>400,000</u> | <u>(957,138)</u> | <u>7,414,428</u> |
| Three months ended September 30, 2005 | | | | | | |
| Balance as at July 1, 2005 (unaudited) | 6,309,133 | 1,623,423 | 37,775 | – | (204,554)* | 7,765,777 * |
| Net earnings (unaudited) | – | – | – | – | 103,149 | 103,149 |
| Balance as at September 30, 2005 (unaudited) | <u>6,309,133</u> | <u>1,623,423</u> | <u>37,775</u> | <u>–</u> | <u>(101,405)*</u> | <u>7,868,926 *</u> |
| Year ended December 31, 2005 | | | | | | |
| Balance as at December 31, 2004 (audited) | 6,309,133 | 1,623,423 | 37,775 | – | (648,564) | 7,321,767 |
| Net earnings (audited) | – | – | – | – | 590,858 | 590,858 |
| Payment from the State in respect of privatization of the company (audited) | – | – | 1,235 | – | – | 1,235 |
| Dividend proposed for payment (audited) | – | – | – | 1,200,000 | (1,200,000) | – |
| Balance as at December 31, 2005 (audited) | <u>6,309,133</u> | <u>1,623,423</u> | <u>39,010</u> | <u>1,200,000</u> | <u>(1,257,706)</u> | <u>7,913,860</u> |

* Restated, see Note 2D

The notes to the interim financial statements are an integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows

Reported amounts

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|---|---|------------------|--|------------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Cash flows from operating activities | | | | | |
| Net earnings | 700,568 | 547,159 | 244,990 | 103,149 | 590,858 |
| Adjustments to reconcile net earnings to net cash flows from operating activities (see A below) | 1,603,114 | 1,254,402* | 619,281 | 428,611* | 2,127,730 |
| Net cash generated by operating activities | 2,303,682 | 1,801,561* | 864,271 | 531,760* | 2,718,588 |
| Cash flows from investing activities | | | | | |
| Investment in fixed assets | (805,096) | (1,330,827) | (273,155) | (347,247) | (1,694,071) |
| Proceeds from disposal of fixed assets and sale of operations | 33,696 | 144,528 | 10,336 | 18,988 | 147,810 |
| Investment in long-term deposits and investments | (5,125) | (7,218) | (276) | (236) | (10,068) |
| Redemption of long-term deposits and investments | 58,976 | 93,239 | 46,092 | 84,630 | 91,431 |
| Decrease (increase) in short-term investments, net | 99,512 | (717,270) | 175,019 | (527,234) | (972,260) |
| Investment in investee companies | (15,424) | (6,474) | (4,571) | (728) | (18,836) |
| Investment in other assets | (95,513) | (68,872) | (54,727) | (29,430) | (91,893) |
| Net cash used in investing activities | (728,974) | (1,892,894)* | (101,282) | (801,257)* | (2,547,887) |
| Cash flows from financing activities | | | | | |
| Issue of debentures (after deduction of issue expenses) | – | 1,702,265 | – | 464,029 | 1,702,265 |
| Repayment of other debentures | (235,906) | (182,108) | (56,850) | (61,801) | (267,332) |
| Receipt of long-term loans | – | 442,000 | – | 24,500 | 474,521 |
| Repayment of long-term loans | (1,174,589) | (1,257,767) | (783,979) | (205,321) | (1,365,578) |
| Receipt (repayment) of short-term bank credit, net | 65,494 | 20,734 | 9,718 | 19,685 | (12,911) |
| Dividend paid | (1,200,000) | – | – | – | – |
| Net cash generated by (used in) financing activities | (2,545,001) | 725,124 | (831,111) | 241,092 | 530,965 |
| Increase (decrease) in cash and cash equivalents | (970,293) | 633,791 | (68,122) | (28,405) | 701,666 |
| Balance of cash and cash equivalents at the beginning of the period | 2,158,773 | 1,457,107 | 1,256,602 | 2,119,303 | 1,457,107 |
| Balance of cash and cash equivalents at the end of the period | 1,188,480 | 2,090,898 | 1,188,480 | 2,090,898 | 2,158,773 |

* Reclassified

The notes to the interim financial statements are integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows (Contd.)

Reported amounts

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|--|---|-------------------|--|-----------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| A – Adjustments to reconcile net earnings to net cash flows from operating activities | | | | | |
| Revenue and expenses not involving cash flows: | | | | | |
| Depreciation | 1,707,582 | 1,749,207 | 563,089 | 587,890 | 2,330,711 |
| Deferred taxes | 115,725 | 132,212 | 83,485 | 58,462 | 144,035 |
| Company's equity in losses (gains) of affiliated companies | (3,735) | 13,107 | (2,112) | 1,940 | 12,645 |
| Minority share in gains (losses) of a subsidiary | 26 | (8,971) | – | 8 | (8,942) |
| Decrease in employee severance benefits, net | (191,143) | (345,298) | (37,050) | (230,138) | (407,265) |
| Gain on disposal of fixed assets | (35,797) | (5,346) | (23,610) | (2,597) | (5,715) |
| Gain from sale of operations | – | (103,869) | – | – | (103,869) |
| Provision for impairment of the value of investments | – | 5,868 | – | 1,168 | 5,868 |
| Erosion (appreciation) and interest on long-term deposits and investments | 1,128 | 14,881 | (2) | 1,735 | 22,170 |
| Erosion (appreciation) of short-term investments, net | (3,167) | (62,589) | (7,473) | (35,927) | (60,396) |
| Appreciation (erosion) of long-term liabilities: | | | | | |
| Debentures | 24,724 | (129,083) | (76,746) | (10,668) | (69,730) |
| Long-term loans and other liabilities | 28,382 | 152,841 | 26,813 | 76,783 | 129,032 |
| Amortization of other assets and deferred expenses | 83,056 | 143,361 | 42,404 | 47,637 | 196,015 |
| Changes in asset and liability items: | | | | | |
| Decrease (increase) in broadcasting rights | (23,420) | (20,839) | 11,076 | (1,721) | (14,004) |
| Decrease (increase) in trade receivables | 40,717 | (98,673) | (1,537) | (84,155) | (63,298) |
| Decrease (increase) in other receivables and debit balances | 4,599 | 39,888 | (8,586) | 63,841 | 24,600 |
| Decrease (increase) in inventory | 42,741 | 43,040 | 35,718 | 23,937 | 75,943 |
| Decrease (increase) in materials and spare parts | (14,526) | (5,552)* | 6,936 | 28,264* | 24,952 |
| Increase in trade payables | (184,131) | (218,029) | 14,913 | (48,759) | (112,461) |
| Increase (decrease) in other current liabilities | 6,715 | (28,361) | (4,188) | (52,679) | 20,733 |
| Increase (decrease) in deferred revenues | 3,638 | (13,393) | (3,849) | 3,590 | (13,294) |
| | 1,603,114 | 1,254,402* | 619,281 | 428,611* | 2,127,730 |
| B– Non-cash transactions | | | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit | 215,065 | 133,125 | 215,065 | 133,125 | 124,719 |
| Sale of fixed assets on credit | 43,699 | – | 43,699 | – | 17,089 |

* Reclassified

The notes to the interim financial statements are an integral part thereof.

Notes to the Financial Statements as at September 30, 2006

NOTE 1 – GENERAL

- A.** These interim statements were prepared according to the generally accepted accounting principles applicable to the preparation of financial statements for interim periods pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB) and to the provisions of Section 4 of the Securities Regulations (Periodic and immediate reports), 5730-1970.
- B.** These statements should be read in conjunction with the annual financial statements of the Company and its subsidiaries as at December 31, 2005 and for the year then ended, and their accompanying notes (hereinafter – the Annual Reports).
- C.** The Company presents in the notes to the interim financial statements only those significant changes in its business and legal environment that occurred from the date of the latest annual financial statements, published on March 1, 2006, until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the fields of competition in cellular telephone markets, international communication services, domestic communication services and multi-channel television services, appear in Note 1 to the Company's annual financial statements as at December 31, 2005. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:

- (1) Further to Note 1C. to the financial statements as at December 31, 2005, concerning a gradual reduction in the percentage of royalties from 3.5% to 3% – on August 9, 2006, the Knesset Finance Committee approved regulations promulgated by the Minister of Communications with the approval of the Finance Minister, for a reduction in the royalty rate for all the licensees who are required to pay royalties, effective from January 1, 2006, by 0.5% each year until the rate reaches 1% per year in 2010. In addition, the Ministry announced that it would work for amendment of the regulations in a way that would grant the Company retroactive exemption commencing January 2004 from the duty to pay royalties in respect of revenues from services which have been opened to competition.

With the approval of the regulations, the Group's royalty expense was reduced by approximately NIS 29 million in the third quarter, in respect of the nine-month period ended September 30, 2006.

- (2) Further to Note 1D. to the financial statements as at December 31, 2005, concerning an appeal filed by the Company in 2001 in the Antitrust Court to change the announcement of the Company's monopoly in the basic telephony service (fixed-line domestic telephony) – following the Company's request that the court expedite the hearing of the appeal, the Company agreed, at the proposal of the court (in view of the time elapsed since it was filed together with an economic opinion), to withdraw the appeal, and it was struck out on August 2, 2006. The Company is preparing to file a new and revised application to the Antitrust Commissioner. In the opinion of the Company, the mobile telephony market is an alternative market for fixed-line telephony, and this fact is reinforced by new and up-to-date data which have accumulated during the period since the appeal was filed in 2001.
- (3) Further to Note 1E(1)a. to the financial statements as at December 31, 2005, concerning revision of the Company's tariffs – on July 1, 2006, the Communications Regulations (Telecommunications and broadcasts) (Payment for telecommunication services), 5766-2006 and the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunication services and their linkage) (Amendment No. 2), 5766-2006, came into effect. According to the regulations and based on the tariff update formula prescribed in the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunication services and their linkage), 5763-2003, the average reduction of the controlled tariffs of the Company determined according to Section 15(a) of the Communications Law, applicable from July 1, 2006, is an average rate of 0.36% (excluding the reduction of VAT by 1% which took effect on the same date). This reduction is based on a change of approximately 2.4% in the Consumer Price Index, less an average efficiency factor of approximately 2.7%. In addition, the Communications Regulations (Telecommunications and broadcasts) (Payment for interconnect) (Amendment), 5766-2006 were amended, whereby interconnect fees were reduced by approximately 2% (including the 1% VAT reduction), came into effect on the same date.

Notes to the Financial Statements as at September 30, 2006

NOTE 1 – GENERAL (CONTD.)

- (4) Further to Note 1E(1)c. to the financial statements as at December 31, 2005, concerning regulations relating to proceedings and conditions for receipt of a special general license for providing fixed-line domestic communications services without a universal obligation – to the best of the Company's knowledge, during the first quarter of 2006 another two licenses were granted to two additional operators. The subsidiary Bezeq International Ltd. filed an application for such a license. Since the Ministry of Communications had not yet responded to the subsidiary's application for a general license, on July 25, 2006, the subsidiary filed an application for extension of the term of the marketing trial license for VOIP services until the date of the Ministry of Communications' decision on the matter of the general license. On August 31, 2006, the Ministry of Communications notified the subsidiary of extension of the term of the marketing trial license to February 28, 2007.

During the first quarter of 2006, Pelephone received the license for marketing trials in VOIP technology which it had applied for. In addition, Pelephone applied for a special general license.

- (5) In September 2006, a Government decision was made in the matter of "Increasing competition in telephony – Virtual operators and broadband access operators", whereby the Minister of Communications is required to examine and formulate a policy on the subject of the provision of fixed-line telephony services by means of broadband access over the internet, and to do so by no later than April 1, 2007. In addition, it was decided to impose a duty on the Director General of the Ministry of Communications together with the Supervisor of Budgets at the Ministry of Finance to examine the issue of the activities of virtual mobile telephone operators and to formulate, if necessary, a model of action for encouraging the activities of virtual operators, and to do so by May 1, 2007.

On October 25, 2006, the Ministry of Communications announced a hearing for the relevant communications operators in the matter of VOB policy, in order to complete the policy formulation process in this area. According to the Ministry's press release, the hearing focuses on the structure of the interconnect tariff that will be paid to the VOB licensee for completing a call in the "VOB network" – according to the press release, the Ministry of Communications is considering a number of alternatives: (a) a reciprocity arrangement whereby the interconnect tariff for call completion in a network will be the same as the interconnect payment for call completion in a public telecommunication network of a domestic operator; (b) the interconnect tariff for call completion in a licensee's network will depend on a proportion of the volume of traffic; (c) a combination of those two alternatives.

- (6) Further to Note 1E(1)f. to the financial statements as at December 31, 2005, concerning a numbering plan for number portability records – during February and March 2006, further correspondence with the Ministries of Communications and Finance concerned the inability of operators, including the Company, to comply with the timetables set. On August 23, 2006 the Ministers of Communications and Finance announced that application of the numbering plan would not be postponed beyond September 1, 2006. In their notice, the Ministers also said that the Director General of the Ministry of Communications had recommended that if the plan is not implemented by September 1, 2006, "the relevant communication companies would be declared to be in violation of the law, with all the implications of such a declaration". Following this decision, on August 24, 2006, both the Company and Pelephone (together with other cellular operators) filed petitions in the High Court of Justice for grant of an interlocutory injunction against the Government of Israel and the Minister of Communications. The petitioners allege, *inter alia*, that even though they worked hard to implement the plan, investing enormous resources to do so, they are unable to meet the unrealistic timetable prescribed in the law for its implementation. As background to their arguments, the petitioners allege that the Ministry of Communications failed to prepare a numbering plan for number portability or the payment structure that would apply among the entities, as it was required to do under the provisions of the law. The State has filed its preliminary response to the High Court of Justice, in which it applies for dismissal of the petition *in limine*. At this stage, the Company and Pelephone are unable to assess the effects the above might have on them.

Notes to the Financial Statements as at September 30, 2006

NOTE 1 – GENERAL (CONTD.)

- (7) Further to Note 1H to the financial statements as at December 31, 2005, concerning the resolution of the Board of Directors of the Company on March 1, 2006, to recommend to the General Meeting of the shareholders of the Company, the distribution of a cash dividend to the shareholders in the amount of NIS 1,200,000,193, which as at the date of the distribution constitutes NIS 0.4606446 per share – the Special General Meeting of the shareholders of the Company which convened on March 23, 2006, approved the distribution of the dividend. The dividend was distributed on April 16, 2006.

On October 30, 2006, the Company distributed to its shareholders an additional cash dividend of NIS 400,000,064, which as at the date of the distribution constitutes NIS 0.1535482 per share

- (8) The Ministry of Communications notified the Company on May 9, 2006, of its intention to call in a guarantee of NIS 7 million out of the bank guarantee of \$10 million which the Company deposited for securing fulfillment of the terms of its license, due to its position that the Company launched a campaign in a way which deviates from the rules of the regulation applicable to campaigns. The position of the Company is that it does not require the approval of the Ministry for marketing campaigns. The Company intends to exhaust every legal avenue open to it on this matter, and its first step, taken on May 24, 2006, was to appeal the Minister's decision. The appeal has been heard but no decision has yet been made. The financial statements do not include a provision in respect of this matter.
- (9) In May 2006 the Company received a letter from the Antitrust Authority concerning complaints by certain communications operators of actions ostensibly being taken by the Company against those operators and a complaint by one of the operators which was received from the Ministry of Communications. According to the operators, the actions constitute abuse of the Company's monopolistic power. The Company was requested to submit to the Authority and the Ministry both data and answers to questions in the letter, and has done so.
- (10) On May 23, 2006, investigators from the Antitrust Authority appeared at the Company's offices and presented a search warrant issued by the Magistrate's Court for the Company's offices and permitting them to seize any document or object required for their investigation. According to the warrant, the cause for its grant was suspicion of abuse of monopoly status according to Section 29A of the Antitrust Law together with Section 47(A)(4a) of that law and/or unreasonable refusal to provide a monopoly asset or service according to Section 29 of the Antitrust Law. During the search, which has not yet been completed, the investigators collected various documents, including computerized material, and several employees were requested to accompany the investigators to the Antitrust Authority's offices for questioning. The Company cooperated fully with the Authority's investigators. To the best of the Company's knowledge, the investigation is still in progress, and accordingly, the Company, relying on its external legal adviser who is handling the case on its behalf, is unable, at this stage, to estimate the outcome and implications of the investigation, including the possibility of indictments being filed and/or civil proceedings being instituted against the Company.
- (11) Further to Note 1E(2)a. to the financial statements as at December 31, 2005, concerning the decision of the Minister of Communications to oblige the Company to transfer to Cellcom interconnect payments according to actual traffic – a settlement agreement was signed between the Company and Cellcom, under which the Company paid Cellcom the agreed amount. There is no effect on the financial statements of the Company for the reporting period, due to an existing provision recorded in the Company's books.
- (12) Further to Note 9F to the financial statements as at December 31, 2005, concerning the Company's satellite communication operations, the Company has terminated its contacts with potential investors and is currently considering further action in this area.
- (13) Further to Note 1E(1)d. to the financial statements as at December 31, 2005, on October 16, 2006, the Ministry of Communications announced its intention to extend the temporary order period for nine months. The Company has expressed its objection to the aforementioned.

Notes to the Financial Statements as at September 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. GENERAL

The significant accounting policies applied in these financial statements are consistent with those applied in the annual financial statements, except as stated in this Note.

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS

(1) Accounting Standard No. 20 (Amended) – Accounting treatment of goodwill and intangible assets in the acquisition of an investee company

Commencing January 1, 2006, the Company has applied Accounting Standard No. 20 (Amended) ("the Standard") of the Israeli Accounting Standards Board ("IASB"). The Standard prescribes the accounting treatment for goodwill and intangible assets upon acquisition of a subsidiary and of an investee company which is not a subsidiary, including a company under joint control.

The principal changes set out in the Standard as compared with the principles applied in the past are: attribution of the surplus cost of the acquisition of investment in an investee company also to identifiable intangible assets of the acquired company; a distinction between intangible assets having a defined useful life and intangible assets of an indefinite useful life; immediate recognition as gain, on the date of acquisition, in the statement of income, of negative goodwill created in the acquisition after deduction of intangible assets and non-financial assets of the investee company; termination of the systematic deduction of positive goodwill and intangible assets with an indefinite useful life; distinction between goodwill of a subsidiary and of an investee company which is not a subsidiary for the matter of impairment. Comparative figures were not restated.

The amounts of amortization of goodwill, the deduction of which was terminated on January 1, 2006, in the nine-month and three-month periods ended September 30, 2005 and in the year 2005, were NIS 69,837,000, NIS 23,278,000 and NIS 93,112,000, respectively (see also Note 11).

(2) Accounting Standard No. 21 – Earnings per share

Commencing January 1, 2006, the Company has applied Accounting Standard No. 21 (Amended) ("the Standard") of the IASB. Pursuant to the Standard, the Company computes the basic earnings per share with regard to profit or loss, as well as the basic earnings per share with regard to profit or loss from ongoing operations, attributed to the ordinary shareholders. The basic earnings per share is calculated by dividing the profit or loss attributed to the ordinary shareholders, by the weighted average of the number of ordinary shares in circulation during the period. For the purpose of calculating diluted earnings per share, the Company adjusted the profit or the loss attributed to the ordinary shareholders, and the weighted average of the number of ordinary shares in circulation, in respect of the effects of all the diluted potential ordinary shares. The Company's equity in the earnings of investee companies was computed according to its equity in the earnings per share of those companies, multiplied by the number of shares the Company holds. The initial application of the Standard did not affect the earnings per share of the Company.

(3) Accounting Standard No. 22 – Financial instruments: disclosure and presentation

Commencing January 1, 2006, the Company has applied Accounting Standard No. 22 ("the Standard") of the IASB. The Standard sets out the rules for stating financial instruments in the financial statements and details the proper disclosure required for them. In addition, the Standard determines the manner of classification of financial instruments as financial liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which financial assets and financial liabilities should be set off. The Standard cancels Opinion 53 – Accounting treatment of convertible liabilities, and Opinion 48 –

Notes to the Financial Statements as at September 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS (CONTD.)

Accounting treatment of option warrants. The Standard was adopted on a prospective basis. Comparison figures relating to prior periods were not restated.

Following the first-time adoption of the Standard, the Company set off deferred issuance expenses of approximately NIS 9 million from the debenture and loan items.

(4) Accounting Standard No. 24 – Share-based payment

Commencing January 1, 2006, the Company has applied Accounting Standard No. 24 ("the Standard") of the IASB. Pursuant to the provisions of the Standard, the Company will recognize share-based payment transactions in its financial statements including transactions with employees or other parties that must be settled in equity instruments, in cash or by other assets. Share-based payment transactions in which goods or services are received will be reported at their fair value.

Regarding transactions which are settled in capital instruments, the Standard applies to grants made after March 15, 2005 but which had not yet vested by January 1, 2006. In the same manner, the Standard applies to changes which occurred in the terms of the transactions settled in capital instruments which were made after March 15, 2005, even if the grants in respect of which the changes were made were prior to that date. The first-time application of the Standard did not affect the results of operations and the financial condition of the Group.

(5) Accounting Standard No. 25 – Revenues

Commencing January 1, 2006, the Company has applied Accounting Standard No. 25 ("the Standard") of the IASB. The Standard deals with recognition of revenues from three types of transactions: the sale of goods, the provision of services, and the use made by others of the company's interest-yielding assets, royalties and dividends, and it prescribes the accounting treatment required (rules of recognition, measurement and disclosure) for those three types of transaction. The initial application of the Standard did not affect the results of operations and the financial condition of the Group.

As of January 1, 2006, the Company has applied the IASB published Clarification No. 8 – "Reporting income on a gross basis or a net basis" ("the Clarification"). The Clarification is based on the professional publication EITF 99-19 of the Emerging Issues Task Force in the USA. According to the Clarification, an entity operating as an agency or as a broker without bearing the risks and rewards deriving from the transaction, will state its income on a gross or a net basis. Conversely, an entity operating as a principal supplier and bearing the risks and rewards deriving from the transaction, will state its income on a gross basis. The Clarification provides a list of indicators to be considered in order to determine the basis on which income should be reported – gross or net. Since in the past the Company treated the matter of gross or net income in accordance with the provisions of EITF 99-19, the first-time application of the new Clarification had no material effect on the Company.

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

(1) Accounting Standard No. 29 – Adoption of international financial reporting (IFRS)

In July 2006 the IASB published Accounting Standard No. 29 - Adoption of International Financial Reporting Standards (IFRS) ("the Standard"). The Standard states that entities subject to the Securities Law, 5728-1968 and which are required to report in accordance with the regulations of that law, will prepare their financial statements according to IFRS standards for periods commencing January 1, 2008. The Standard allows earlier adoption, commencing from the financial statements which will be published after July 31, 2006. The IFRS standards will be adopted for the first time together with application of the provisions of IFRS Standard 1 – First-time Adoption of IFRS Standards, for the purpose of the transition. The Company is examining

Notes to the Financial Statements as at September 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION (CONTD.)

the effects of the Standard on its financial statements, including the possibility of early application of the IFRS standards.

(2) Accounting Standard No. 26 – Inventory

In August 2006 the IASB published Accounting Standard No. 26 – Inventory ("the Standard"). The Standard provides guidelines for determining the cost of the inventory and its subsequent recognition as an expense, as well as determining the impairment of the value of the inventory to its net realization value. The Standard also provides guidelines for cost formulas to be used for attributing costs to different types of inventory. The Standard will apply to financial statements for periods commencing January 1, 2007, or later. The Company estimates that application of the Standard is not expected to have a significant effect on the results and financial situation of the Company.

(3) Accounting Standard No. 27 – Fixed assets

In August 2006 the IASB published Accounting Standard No. 27 – Fixed assets. ("the Standard"). The Standard sets out rules for the recognition, measurement and disposal of fixed asset items and the disclosure required in respect thereof. The Standard states, *inter alia*, that upon first-time recognition of a fixed asset item, the entity must estimate and include as part of the cost of the item the costs that will be generated by it in respect of a commitment to dismantle and transfer the item and restoration of the place where it is located. Additionally, the Standard determines that a group of similar fixed asset items will be measured at cost less accumulated depreciation, and net of losses from impairment of value, or alternatively, in a revalued amount less accumulated depreciation, where an increase in the value of an asset as a result of revaluation beyond its initial cost, will be charged directly to the shareholders' equity as a revaluation reserve line item. Any part of a fixed asset with a cost which is significant in relation to the total cost of the item, will be depreciated separately, including costs of significant periodic tests. In addition, the Standard states that an entity must review, at least at the end of every fiscal year, the residual value, useful life, and depreciation method used for the asset. The Standard also states that a fixed asset item purchased in exchange for another, non-financial item is essentially a commercial transaction, "will be measured at fair value".

The Standard will apply to financial statements for periods commencing January 1, 2007. An entity which elects to use the revaluation method for measuring fixed assets for the first time on January 1, 2007 will recognize a revaluation reserve on that date in the amount of the difference between the revalued amount of the asset on that date, and its book cost. In addition, an entity which did not include in the past, in the cost of a fixed asset, at the time of first recognition, the preliminary estimate of the costs of liquidation and transfer of the item and restoration of the place where it is located, will –

- (a) measure the above liability as at January 1, 2007, in accordance with accepted accounting principles;
- (b) calculate the amount which would have been included in the cost of the relevant asset at the time the liability first came into being, by capitalization of the amount of that liability in section (a) above as at the date on which the liability came into being for the first time ("the Capitalized Amount");
- (c) calculate the accumulated depreciation on the Capitalized Amount as at January 1, 2007, on the basis of the useful life of the asset on that date.
- (d) The difference between the amount to be charged to the asset according to sections (b) and (c) above and the amount of the liability according to section (a) above, will be charged to earnings.

Other than the above, adoption of the Standard will be by way of retroactive application.

Notes to the Financial Statements as at September 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION (CONTD.)

The Company is examining the effects of the Standard, but is unable, at this stage, to assess the extent the effect of its application on its financial statements.

D. RESTATEMENT

Further to Note 2FF to the financial statements as at December 31, 2005, the financial statements as at September 30, 2005 and December 31, 2005 were adjusted retroactively by way of restatement in order to reflect the recording of a liability of the Company to its retirees, as shown below:

(1) Effect on the consolidated balance sheet as at September 30, 2005

| | <u>As previously reported</u> | <u>Effect of restatement</u> | <u>As reported in these financial statements</u> |
|-----------------------|-----------------------------------|----------------------------------|--|
| | <u>NIS thousands</u> | <u>NIS thousands</u> | <u>NIS thousands</u> |
| Current liabilities | 5,075,708 | 10,000 | 5,085,708 |
| Long-term liabilities | 7,561,784 | 134,000 | 7,695,784 |
| Shareholders' equity | 8,012,926 | (144,000) | 7,868,926 |

(2) Effect on retained earnings (deficit)

| | <u>As at September 30</u> | <u>As at June 30</u> | <u>As at December 31</u> |
|---|---------------------------|----------------------|--------------------------|
| | <u>2005</u> | <u>2005</u> | <u>2004</u> |
| As previously reported | 42,595 | (60,554) | (504,564) |
| Effect of restatement | (144,000) | (144,000) | (144,000) |
| As reported in these financial statements | <u>(101,405)</u> | <u>(204,554)</u> | <u>(648,564)</u> |

The effect of the amendment on the statement of operations in the reported periods is marginal.

NOTE 3 – RATES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES

The changes that occurred in the consumer price index and in the exchange rates of the US dollar and the euro in the period of account, are as follows:

| | <u>Consumer price index</u> | <u>Exchange rate of the US dollar</u> | <u>Exchange rate of the euro</u> |
|--------------------------------------|---------------------------------|---|--------------------------------------|
| | <u>%</u> | <u>%</u> | <u>%</u> |
| For the nine-month period ended: | | | |
| September 30, 2006 | 0.78 | (6.54) | 0.16 |
| September 30, 2005 | 1.89 | 6.73 | (5.94) |
| For the three-month period ended: | | | |
| September 30, 2006 | (0.76) | (3.11) | (3.34) |
| September 30, 2005 | 1.38 | 0.52 | 0.01 |
| For the year ended December 31, 2005 | 2.39 | 6.85 | (7.33) |

Notes to the Financial Statements as at September 30, 2006

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS")

In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, and commenced provision of services in July 2000. Since starting operations, DBS has accumulated considerable losses. The loss for 2005 amounted to approximately NIS 328 million and the loss for the nine-month period ended September 30, 2006 amounted to approximately NIS 218 million. As a result of these losses, DBS's capital deficit and working capital deficit as at September 30, 2006 amounted to approximately NIS 3,815 million and NIS 580 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,562 million (before interest and linkage). The Company's equity in the accumulated losses of DBS since its investment (excluding deduction of goodwill) is approximately NIS 1,781 million, of which approximately NIS 207 million was recorded in the nine-month period ended September 30, 2006 (DBS's losses for the period, net of the increase in new loans given by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 111 million. This debt has not yet been fully repaid, and recently the Company formulated an arrangement with DBS for its collection.

The terms of the long-term loans which DBS received from banks, the balance of which as at September 30, 2006 is NIS 1,324 million (including current maturities), impose various restrictions on DBS, which include, *inter alia* – restrictions relating to encumbrance or sale of certain assets, restrictions on receipt of credit from other banks without prior approval, a restriction on repayment of shareholders loans, and a demand to comply with financial criteria ("the Conditions"). As at September 30, 2006, DBS is in compliance with the Conditions prescribed in the financing agreements (after a benefit which was granted in connection with the financial criteria in respect of the third quarter of 2006). In view of the projections of the Management of DBS regarding its business results for the coming years, DBS is working with the banks to revise the financial stipulations in the financing agreement. DBS is also negotiating with the banks to settle a dispute relating to insurance obligations prescribed in the financing agreement.

During April and May 2005, the Company and DBS filed petitions in the High Court of Justice for grant of an order *nisi* against the Minister of Communications, declaring that the decisions described above are null and void. The petitions, which were heard on October 11, 2005, raised questions of principle which are far from simple, both factually and legally, which were brought into sharp focus during the hearing. The Court has not yet given its decision.

On March 21, 2006, the Company received a letter from the Minister of Communications, stating that after examining the implications of further injections of funds into DBS for the promotion and consolidation of competition in fixed-line domestic communications, and based on the business plans of DBS for 2006 which were presented to the Minister of Communications, according to which the injections needed in 2006 amount to NIS 55 million, the Minister of Communications is considering placing a limit on injections of funds in 2006 in the following manner:

- (1) The Company's part in the total injections into DBS would not exceed 40%.
- (2) The part of the other DBS shareholders and of the banks or financing institutions would not exceed 60%.
- (3) The Company or an entity acting on its behalf would not provide a guarantee to the shareholders, the banks or institutional financing entities, or any similar commitment, for securing their part in the injections or in credit granted by them to DBS.
- (4) Towards the end of 2006, the subject of the injections, insofar as required in future years, would be re-examined.

The Company sent its response to the letter on April 2, 2006, in which it gave notice that it opposes the decision being considered by the Ministry of Communications, which it believes to be *ultra vires*, and is requesting a hearing to explain its position and make its arguments orally before the Minister of Communications. As at the date of publication of these financial statements, the Company had not yet been invited to argue its position before the Minister.

Notes to the Financial Statements as at September 30, 2006

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (CONTD.)

As at the date of approval of the financial statements, DBS is working to obtain additional financial resources which will enable it to achieve its targets for the coming year. If those resources cannot be obtained, DBS will operate in accordance with an alternative business plan which does not necessitate additional resources beyond those already existing. The Management of DBS believes, based on up-to-date projections and on the alternative business plan, that the prospects for arranging the financial resources required by DBS in the coming year are good.

On August 2, 2006 the Company and DBS filed merger notices to the Antitrust Commissioner ("the Commissioner"), concerning exercise of options for DBS shares by the Company, which would increase the percentage of the Company's holding in DBS from approximately 49.8% to approximately 58%. The Commissioner's approval for increasing the Company's holding in DBS to more than 50% had already been given (on certain conditions) in the past (on January 2, 2005), but expired one year later, and therefore the companies have submitted a renewed request for approval of the merger. Subsequently, the Antitrust Authority demanded details and data from the Company and DBS, relating to the merger application, which they provided. With the consent of the parties, the date by which the Antitrust Commissioner will give his decision was postponed to November 9, 2006.

B. GOLDNET COMMUNICATION SERVICES, A REGISTERED PARTNERSHIP ("GOLDNET")

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

Upon fulfillment of all the suspending terms prescribed in the acquisition agreement, Goldnet will cease to provide services.

C. MERGER OF THE OPERATIONS OF BEZEQCALL COMMUNICATIONS LTD. AND BEZEQ INTERNATIONAL LTD.

At the end of July 2006, the Company began examining a possible merger of the operations of the wholly-owned subsidiary BezeqCall Communications Ltd. (whose business is in network end points) and the wholly-owned subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for businesses). On October 5, 2006 the Antitrust Commissioner gave his approval for the merger. Completion of the merger requires, *inter alia*, the approval of the Ministry of Communications for re-assigning the network end point license of BezeqCall to Bezeq International.

In addition, on October 15, 2006, BezeqCall signed an agreement for the acquisition of all the operations of Tadiran Communication Services Ltd., a limited partnership, in consideration of NIS 93 million subject to certain adjustments depending on the transaction closing date. The transaction is subject to a due diligence process and to receipt of approvals, among them that of the Antitrust Commissioner.

NOTE 5 – LONG-TERM LOANS

Further to Note 13D(1) to the financial statements as at December 31, 2005, following repayment of the balance of a long-term loan in the amount of approximately NIS 460,000, the Company's commitment to restrictions imposed on it in that loan agreement came to an end, including a duty to comply with a ratio of net financial debt to EBITDA, which was not to exceed 3 : 1 for the Group.

Notes to the Financial Statements as at September 30, 2006

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

EARLY RETIREMENT PLAN

Further to Note 16D to the financial statements as at December 31, 2005 – the negotiations between the Company's Management and the employees' representatives in connection with a change in the organizational structure, retirement / layoff of employees and a new labor agreement, are at an advanced stage of drafting the agreement. The agreement will require the approval of the New General Federation of Workers ("the Histadrut") and the Board of Directors of the Company.

1. On April 27, 2006 the Company received a "Notice of strike action or work to rule" pursuant to the Resolution of Labor Disputes Law, 5717-1957, applicable from May 14, 2006. Following the notice of the parties to the Labor Court, this proceeding was struck out.
2. On October 5, 2006 the Company received a "Notice of strike action or work to rule" pursuant to the Resolution of Labor Disputes Law, 5717-1957, which was delivered by the person who handles the Bezeq portfolio at the Histadrut ("the Notice").

The Notice is of a strike at the Company commencing on October 20, 2006, which was declared by the Histadrut and approved, according to the Notice, by the National Central Executive of the Histadrut.

The issues in dispute, according to the Notice, are as follows:

- "a. A unilateral decision concerning the implementation of structural/organizational changes in the area of activity of virtual operators, the meaning of which is a decrease in the activities of the employer in the field of fixed-line telephony.
- b. Even though this decision of the employer has significant implications for the terms of employment, status, rights, pay and occupational security of the workers, since it will necessarily narrow the activities of the employer, it was made, as noted, unilaterally and without negotiating for the execution of a collective agreement with the competent employees' representatives as to the implications for and harm to the workers.
- c. Conduct in bad faith in a way which is unacceptable in labor relations as a whole and in labor relations in public service in particular."

In its letter to the Histadrut and to the chairman of the employees' representatives immediate after receipt of the Notice, the Company stated that there was no justification for allegations against it in the matters described in the Notice and that it was not a party to the dispute, and demanded that they withdraw the notice and not take any actions and/or apply any sanctions or disruptions which could harm the Company, its workers and its customers. Following an approach by the Company's Management, the employees' representatives announced that it would postpone its sanctions for 90 days, in order to enable talks with the Ministry of Communications during that time. In addition, the Company requested of the Director General of the Ministry of Communications to hold a joint hearing with representatives of the Management and the employees.

NOTE 7 – CONTINGENT LIABILITIES

A. CLAIMS AND CONTINGENT LIABILITIES

The Company and the investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 19A to the annual financial statements of the Company as at December 31, 2005, and published on March 1, 2006. No material changes in contingent liabilities have occurred up to the date of signing these financial statements, other than the following:

Notes to the Financial Statements as at September 30, 2006

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (1) Further to Note 19A(2)(a) to the financial statements as at December 31, 2005, concerning an investigation by the Antitrust Authority regarding *prima facie* suspicion of restrictive agreements in public and private switching (NEP), on October 25, 2006, the Antitrust Tribunal affirmed an agreed order between the Company and its subsidiary BezeqCall Communications Ltd. and the Antitrust Authority. The agreed order includes an undertaking to pay the State Treasury NIS 2 million, without admitting to violation of the Antitrust Law, and the Authority's confirmation that it will refrain from instituting enforcement proceedings, including a determination under section 43 of the Antitrust Law, against Bezeq and BezeqCall Communications Ltd., or any officer of them, present or past, with respect to arrangements made in the field of public switching or private switching (NEP).
- (2) Further to Note 19A(4)(b) to the financial statements as at December 31, 2005, concerning different claims relating to recognition of various salary components as pension components and of the notice of a party to the collective dispute ("the Claim") which was filed by the New General Federation of Workers ("the Histadrut") in the name of all the employees of the Company, in which the Histadrut alleged that grossing up payments, the administrative on-call component and clothing allowances ("the Components") which were and are paid to Company employees, are regular pay which form part of the determining salary of every employee, including for the calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hourly pay value and that various payments and provisions should be made in respect thereof, including for pension purposes – on April 4, 2006 the decision of the Jerusalem Regional Labor Court dismissed the Claim and all its component parts filed by the Histadrut in the name of all Company employees.

In its decision, the Court allowed, in full, the argument of the Company that the conduct of the parties over so many years indicates unequivocally that the demands of the Histadrut directly contradict the agreements applicable to the relationships between the parties, which are binding in the circumstances, and therefore those demands should be dismissed. The Court further determined that even if the Components are examined on their merits the Claim would be dismissed, since according to case law, all three Components fall within the definition of "extras" and not "pay", and therefore do not grant entitlement to the reliefs claimed by the Histadrut.

Following an application by the Histadrut, the National Labor Court extended the date for appealing its decision.

Further to Note 19A(4)c. to the financial statements as at December 31, 2005, concerning the claim of a group of employees in the matter of including a number of components as part of the determining salary for pension, on August 6, 2006, a decision was given dismissing the claim and all its parts, and the court ruled that the salary increments are not fictitious extras but genuine and conditional increments and therefore are not part of the basic salary for the computation of the pension or of severance pay, vacation pay, sick pay, retirement grant and acclimatization grant. The decision is subject to a right of appeal by the plaintiffs, and has been appealed.

The financial statements contain a provision of NIS 50 million in respect of the administrative on-call component and in respect of the Components claim. The Company has examined the significance and implications of the decision described above, and has concluded that the conditions do not yet exist for allowing the cancellation or reduction of the provision or part of it.

- (3) Further to Note 19A(9) to the financial statements as at December 31, 2005, concerning a claim filed by a competing international communications operator against the Company and against Bezeq International in the amount of NIS 57 million, for a number of causes relating, *inter alia*, to postponement of implementation of the customer allocation proceeding, a mediation proceeding was commenced between the parties and is now in progress. The Company, relying on its legal advisers, believes that the chances of the claim being dismissed are greater than the chances of it being allowed. The management of Bezeq International believes, considering that its part in the

Notes to the Financial Statements as at September 30, 2006

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

amount of the claim is approximately NIS 29 million and the estimation of its legal advisers that there is a reasonable but not definite chance that Bezeq International will be ordered to pay some part of that amount, that Bezeq International will not sustain material loss beyond the amounts included in the financial statements.

- (4) Further to Note 19A(11) to the financial statements as at December 31, 2005, concerning a claim and application for certification as a class action, in the matter of restitution of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard – on April 16, 2006, the applicant filed an application to amend the application for certification as a class action pursuant to the new Class Action Law, 5766-2006. The Company opposed the application. The Court has not yet given its decision. In the opinion of the legal advisers who are handling the claim on behalf of the Company, against a background of developments and the possibility that the court will allow the applicants to amend their claim following amendment of the Telecommunications Regulations, the chances that the claim will prevail cannot be assessed at this stage.
- (5) Further to Note 19A(13) to the financial statements as at December 31, 2005, concerning a claim and an application for its certification as a class action, in the matter of deception relating to telephone calls to numbers starting with the digits 1-800 and 1-700, which leads consumers to believe that these are free calls even when made from a cellular telephone – on September 5, 2006, a decision was given on the basis of an agreement reached by the parties, whereby the application and the claim were struck out and the Company paid the expenses (NIS 27,500) incurred by the plaintiffs.
- (6) Further to Note 19A(14) to the financial statements as at December 31, 2005, concerning the dismissal of a class action filed against the Company in May 2003, alleging that the Company abuses its monopolistic power and collects enormous sums of money from internet users in that it refuses to install splitters on high-speed (ADSL) lines – on March 27, 2006, the plaintiff filed an appeal in the Supreme Court, in which he petitions for the decision of the District Court dismissing his claim, to be cancelled. The Company filed an application for the appeal to be struck out due to its late filing. Based on the opinion of its external legal advisers, the Company believes that the chances of the appeal being allowed are lower than the chances of its dismissal, and accordingly, no provision has been included in the financial statements in respect of this claim.
- (7) Further to Note 19A(16) to the financial statements as at December 31, 2005, concerning an action for declaratory relief filed in the Regional Labor Court by the Organization of Bezeq Retirees and six Company retirees against the Makefet Fund, the State of Israel and the Company, alleging breach of agreements for binding arrangements which were made at the time when the employees transferred from the civil service to the Company – in the decision on the application for dismissal *in limine* which was filed by the Company, the court decided not to strike out the Organization as a plaintiff and effectively put an end to the claim against Makefet. Regarding the claim against the Company and the State, the court directed that an amended statement of claim be filed, which has been done, and the Company is now required to respond with a statement of defense.
- (8) Further to Note 19A(17) to the financial statements as at December 31, 2005, concerning various claims against the Company and/or against the Makefet Fund filed by employees who retired from the Company on a disability pension due to their medical condition and who had learned, against the background of the pension reform, of a 50% reduction in their pension, and following the report in the same Note on most of those claims (except one) being struck out following amendment of the Supervision of Insurance Law – the last claim in this matter and the allegations of the Company against the Makefet Fund were allowed, and it was ruled that the Makefet Fund must continue to pay the plaintiff a disability pension without charging the Company.

Notes to the Financial Statements as at September 30, 2006

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (9) Further to Note 19A(20) to the financial statements as at December 31, 2005, concerning the dispute between the Company and the Ministry of Communications relating to the payment of royalties in respect of revenues for interconnection from cellular subscribers to Company subscribers, the Company reached an agreement with the Ministry for ending past disputes concerning royalties up to and including 2002, except for two negligible revenue components. As part of this agreement, the Company paid the sum of approximately NIS 17 million to the Ministry of Communications. In the past, the Company's financial statements included a provision for royalties which, in view of the agreement with the Ministry of Communications, is unnecessary. Accordingly, the royalty expenses to the Government of Israel were reduced in the quarter by approximately NIS 36 million, and financing expenses in respect of the royalties were reduced by approximate NIS 31 million. The financial statements still contain a provision for possible disputes commencing from 2003, which the Company's Management believes to be appropriate.
- (10) On April 6, 2006, the Company received a claim together with an application for certification as a class action, which was filed by a private (and inactive) company which is a subscriber of the Company. According to its allegations, the claim concerns the plaintiff being subscribed for the "Free From 7" track and being debited according to that track tariff, without having ordered the service. According to the plaintiff, it has cause of claim in the circumstances of the matter, under the Consumer Protection Law, 5741-1981, the Contracts Law (General part), 5733-1973, and the Unjust Enrichment Law, 5739-1979. The amount of the personal claim is assessed by the plaintiff at NIS 239.18.

The plaintiff has applied for the claim to be certified as a class action in the name of all the subscribers who were debited unlawfully in debit tracks and for certain services of the Company which are listed in the claim. The plaintiff estimates that the financial loss of the members of the group included in the class action could reach millions of shekels per year. The Company filed an application for the claim to be struck *in limine*, and the date for the Company's response to the claim has been postponed until a decision is made on its application (which has not yet been given). Relying on its legal advisers, the Company is unable, at this stage, to estimate the prospects of the claim.

- (11) On May 15, 2006, the Company received a claim with an application for certification as a class action, which was filed in the Jerusalem District Court pursuant to Section 5 of the Class Action Law, 5766-2006. The statement of claim alleges that the Company collected from the plaintiff arrearage interest on amounts of Value Added Tax which the plaintiff should have paid to the Company and which are not part of the services provided by the Company. The amount of the plaintiff's personal claim is NIS 0.33. The plaintiff does not make any assessment of the amount of the class action. The Company filed its response to the application and subsequently, in view of the remarks and suggestion of the court, the parties reached an agreement on the basis of which the court struck out the claim and dismissed the application to certify it as a class action, without an order to pay costs.
- (12) On May 25, 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 a call from a Bezeq line to a cellular line 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 personal claim is NIS 11). The Company is unable, at this stage, based on the lawyer who is handling the claim on his behalf, to estimate the chances of the application for approval.
- (13) Various municipalities and local councils have submitted demands to the Company for retroactive payment of municipal taxes in respect of an increase in the areas of buildings and changes in classification for municipal tax purposes. These claims amount to approximately NIS 60 million. The financial statements include a provision which the Company's Management, relying on the legal advisers who are handling the claims for it, considers appropriate.

Notes to the Financial Statements as at September 30, 2006

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (14) On May 18, 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 (who were imposing sanctions at that time) played some part in the malfunction. The plaintiff alleges that as a result of the malfunction, he incurred economic 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 claim is assessed at about NIS 1,000). On July 16, 2006, the Company filed an application for dismissal *in limine* of the application for certification, arguing that the claim cannot be filed as a class action since it is not among the types of claims defined in the Class Action Law and there are no provisions in any other law under which the claim can be filed. Accordingly, the date for filing the Company's response to the application for certification was postponed until a decision is given on the application for dismissal. In addition, the cable companies filed an application to strike out the claim *in limine*, alleging that they are not liable for the malfunction, and the plaintiff requested an extension for filing his response to that application until completion of the cable companies' investigation of the matter. No decisions have been given as yet on the applications. Relying on its legal advisers, the Company is unable, at this stage, to assess the chances of the application for approval.
- (15) Further to Note 19A(34) to the financial statements as at December 31, 2005. concerning notice of the filing of an application to add Pelephone to an appeal proceeding filed by the owners of rights in land adjoining a cellular communication site operated by Pelephone together with others in Ramat Gan, Pelephone's objection to joining the proceeding as a whole was allowed. Pelephone believes, relying on its legal advisers at this stage of the proceeding that it is at no risk of exposure.
- (16) A number of proceedings were recently submitted to Pelephone, in which local committees were requested to add Pelephone as a party to various appeals filed in appeals committees against the dismissal of claims of impairment of value under Section 197 of the Planning and Construction Law, in respect of the erection of communications installations. Pelephone is studying each application on its merits and making its decisions accordingly. Relying on its legal advisers, Pelephone believes that, at this stage, it is not at risk of material exposure in respect of these proceedings.
- (17) A number of legal proceedings are in progress against Pelephone (whether in administrative petitions, appeals or civil actions), which were filed against the licensing and/or erection of communications sites. Pelephone, the respondent in these proceedings, opposes the reliefs applied for, and believes, relying on its legal advisers that it is not at risk of material exposure from these proceedings.
- (18) On July 12, 2006, a claim was filed against Pelephone in the District Court, together with an application for certification as a class action, in the amount of approximately NIS 251 million. The claim relates to the interpretation of the agreement with Pelephone signed by the plaintiff, concerning the 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. At this stage, Pelephone is unable to assess the chances or the implications of the action.
- (19) On August 10, 2006, a claim was filed in the District Court against Pelephone, Cellcom, and Partner, together with application for certification as a class action for a total of approximately NIS 100 million. The action relates to the time of disconnection of calls made from a cellular network to the Company's network, and alleges that in such a call, where the Company customer initiates its termination, a surplus charge is applied until the actual disconnection of the call. At this stage, Pelephone is unable to assess the prospects and implications of the action.

Notes to the Financial Statements as at September 30, 2006

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (20) Further to Note 19A(25) to the financial statements as at December 31, 2005, concerning a claim filed against Bezeq International by a supplier of a system in the amount of approximately NIS 18.5 million, for enforcement of an agreement for the delivery and installation of a customer care and billing system – following a mediation proceeding between the parties a settlement was reached for the mutual clearance of the claims in the case, against payment of a non-material sum by Bezeq International to the plaintiff. On June 19, 2006, the court validated the settlement agreement and instructed that the court fees paid by the parties be returned to them in full.
- (21) On June 14, 2006, an application was filed in the Tel Aviv District Court for the certification of a claim as a class action against DBS and against the cable companies in connection with the broadcasting of advertisements during World Cup games. According to the applicants, the broadcasting of advertisements 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 530 for each subscriber who purchased the World Cup package, and in total – approximately NIS 106 million for all the members of the group (based on 200,000 World Cup subscribers from the cable companies and DBS together). The Applicants wish to sue DBS on the basis of the Class Action Law, 5766-2006 for cause of deception, violation of a legislated duty, unjust enrichment and breach of a contractual undertaking, in respect of three damages categories: impairment of the value of the World Cup package, harm to autonomy, and causing distress. On September 26, 2006, the Company and the cable companies filed their responses to the Application for Certification. DBS argues that the Application for Certification should be dismissed since the action does not meet the criteria required for its certification as a class action. DBS, relying on its legal advisers, is unable to assess the chances of the claim at this preliminary stage.
- (22) Further to 19A(46) to the financial statements as at December 31, 2005, on October 26, 2006, DBS signed a compromise agreement with the plaintiffs whereby DBS undertakes to broadcast various sports broadcasts on Channel 5 for one complete season of the relevant sectors of the sporting industry during the years 2006-2007 and other sectors of the sporting industry during the years 2007-2008. The agreement determined that the parties will apply to the court in order to grant the compromise agreement the validity of a court judgment. Following execution of a settlement agreement, and prior to its submission to the Court for authorization, it became apparent that some of the rights ascribed to some of the broadcast content that was supposed to be transferred between the channels might not be in the possession of the sports channels on the relevant dates. Submission of the agreement to the Court for authorization has been delayed pending clarification of the status of these rights, and counsel for the plaintiffs is negotiating directly with the CEO of the Sports Channel, to find a fair solution to the situation that has arisen.
- (23) For the provisions 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, most of whose provisions will come into force on January 1, 2007 ("the Radiation Law"), and the Pharmacists Regulations (Radioactive elements and their products), 5740-1980, which regulate the erection and operation of installations and their supervision, 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, where operating permits require the 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 expediting the implementation of National Outline Plan 36B ("NOP 36B"), which deals with building permits for large broadcasting installations. On July 19, 2006, the Company sent a letter

Notes to the Financial Statements as at September 30, 2006

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

to the Ministry for Protection of the Environment, requesting that the Radiation Law be amended so that the application of its provisions concerning the presentation of a permit under the Planning and Construction Law be postponed for three years from the date on which NOP 36B takes effect. 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 Company and Pelephone are unable to assess whether all the permits will be received within the time prescribed in the Radiation Law, and what the aforementioned implications might be.

B. FORWARD TRANSACTIONS

Future Currency Transactions – Accounting Hedging Transactions

Consolidated

| | <u>Currency purchased</u> | <u>Currency payable</u> | <u>Final repayment date</u> | <u>Amounts receivable</u> | <u>Amounts payable</u> |
|---|---------------------------|-------------------------|-----------------------------|---------------------------|------------------------|
| | <u>NIS millions</u> | | | | |
| Forward contracts at predetermined exchange rate (excluding premium/discount) | | | | | |
| | Dollar | NIS | February 2007 | 102 | 102 |
| | Euro | NIS | August 2007 | 1,544 | 1,620 |
| | CPI-linked NIS | NIS | December 2010 | 1,117 | 1,146 |

Future Currency Transactions – Contracts not for Accounting Hedging Purposes

| | <u>Purchased currency</u> | <u>Currency payable</u> | <u>Last repayment date</u> | <u>Scope of commitment</u> |
|---|---------------------------|-------------------------|----------------------------|----------------------------|
| | <u>NIS millions</u> | | | |
| Forward contracts at predetermined exchange rate (excluding premium/discount) | | | | |
| | Dollar | Shekel | June 2007 | 320 |
| | Index | Shekel | December 2007 | 250 |

NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27C to the financial statements as at December 31, 2005, on March 23, 2006 the general meeting of the shareholders of the Company approved the Company entering into an agreement with a company which will be owned and controlled by the shareholders of Ap.Sab.Ar. Holdings Ltd. and will provide the Company with regular management and consultation services, including by means of serving directors and directors who will serve from time to time in the Company and/or in its subsidiaries, for US \$1.2 million per year. The term of the agreement is from October 11, 2005 the date of closing the purchase of 30% of the shares of the Company by Ap.Sab.Ar.) to December 31, 2008, unless one of the parties gives the other three months' notice of its wish to terminate it.

B. BENEFITS FOR DIRECTORS AND CEO

(1) On May 15, 2006 the Audit Committee 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 details of the terms of his employment:

Notes to the Financial Statements as at September 30, 2006

NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

B. BENEFITS FOR DIRECTORS AND CEO (CONTD.)

- a. The Chairman will be employed at an 80% position under a personal employment agreement, at a monthly salary of NIS 150,000 and standard social benefits (managers' insurance, supplementary study fund, company car, driver, expense account, telephone, etc.).
- b. In addition to his regular monthly salary, a once yearly payment (with no accompanying conditions of any kind) in the amount of one million two hundred thousand shekels (linked to the Consumer Price Index).
- c. The commitment will be for an undefined period, where each party has the right to bring the commitment to an end by giving three months' notice.
- d. Insofar as the Company has an employee stock options plan, the Chairman will be included in it in accordance with the criteria of that plan.

- (2) On August 14, 2006 the Board of Directors of the Company approved the sale of a real estate asset of the Company to the CEO of the Company (through a company in his control), for \$630,000 plus VAT. The consideration was set according to the valuation of an external appraiser and after no higher offer was received from other bidders.

- C.** Further to Note 27B to the financial statements of the Company as at December 31, 2005, concerning the new commercial agreement signed between the Company and the Ministry of Defense on behalf of the State of Israel for the provision of communication services by the Company – on August 23, 2006, the Company received a letter from the Antitrust Authority to the legal counsel of the Ministry of Defense and Israel Defense Forces, in which the Authority announced that the agreement does not contradict 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 for its information. Accordingly, the agreement came into force and the parties are acting in accordance with its provisions. The financial statements include revenues in accordance with the new agreement.

Notes to the Financial Statements as at September 30, 2006

NOTE 9 – REVENUES FROM COMMUNICATION SERVICES

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|---|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues from communication services – | | | | | |
| Traffic | 1,013,690 | 1,083,535 | 341,182 | 367,075 | 1,436,615 |
| Fixed fees | 1,964,785 | 1,914,818 | 664,478 | 647,254 | 2,559,559 |
| | 2,978,475 | 2,998,353 | 1,005,660 | 1,014,329 | 3,996,174 |
| Cellular telephone | 2,856,301 | 2,740,753 | 985,535 | 916,766 | 3,643,795 |
| International communications and internet services | 712,532 | 571,918 | 238,060 | 191,163 | 775,532 |
| Multi-channel television | 957,355 | 895,586 | 322,072 | 319,450 | 1,171,318 |
| Installation and sale of equipment to subscribers and miscellaneous | 861,917 | 940,043 | 297,678 | 330,887 | 1,246,947 |
| | 8,366,580 | 8,146,653 | 2,849,005 | 2,772,595 | 10,833,766 |
| Other revenues | 159,951 | 192,564 | 32,399 | 66,124 | 264,920 |
| | 8,526,531 | 8,339,217 | 2,881,404 | 2,838,719 | 11,098,686 |

NOTE 10 – OPERATING AND GENERAL EXPENSES

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|---|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and incidental expenses – | | | | | |
| Operations | 1,360,193 | 1,325,596 | 449,828 | 450,121 | 1,794,458 |
| General and administrative | 529,444 | 500,269 | 180,126 | 173,572 | 684,290 |
| Total salaries and related expenses | 1,889,637 | 1,825,865 | 629,954 | 623,693 | 2,478,748 |
| General expenses | 872,250 | 927,518 | 301,886 | 313,775 | 1,209,169 |
| Materials and spare parts | 611,913 | 743,914 | 197,854 | 244,759 | 1,016,735 |
| Consumption of satellite service content | 333,900 | 309,533 | 117,743 | 107,282 | 419,309 |
| Cellular telephone expenses | 780,049 | 733,253 | 267,113 | 255,611 | 991,066 |
| Building maintenance | 259,005 | 264,132 | 91,487 | 94,327 | 366,630 |
| Services and maintenance by sub-contractors | 326,215 | 329,483 | 111,221 | 118,846 | 422,416 |
| International communication expenses | 299,604 | 199,839 | 103,898 | 69,718 | 277,210 |
| Vehicle maintenance expenses | 142,888 | 131,481 | 50,927 | 50,317 | 181,385 |
| Collection fees | 36,190 | 37,597 | 10,917 | 12,842 | 49,196 |
| | 5,551,651 | 5,502,615 | 1,883,000 | 1,891,170 | 7,411,864 |
| Less – salaries charged to investment in fixed assets | 156,903 | 161,479 | 52,526 | 55,686 | 218,396 |
| | 5,394,748 | 5,341,136 | 1,830,474 | 1,835,484 | 7,193,468 |

Notes to the Financial Statements as at September 30, 2006

NOTE 11 – OTHER INCOME (EXPENSES), NET

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|---|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Provision for employee severance benefits upon early retirement | – | 83,000 | – | – | 83,000 |
| Disposal of assets and impairment of value of fixed assets | – | – | – | – | (830) |
| Provision for impairment and other liabilities in respect of the value of investments in other companies | (7,147) | (5,868) | – | (1,168) | (5,868) |
| Compensation in respect of a settlement agreement | – | 14,483 | – | – | 14,483 |
| Amortization of goodwill | – | (69,837) | – | (23,278) | (93,112) |
| Capital gain from sale of operation | – | 103,869 | – | – | 103,869 |
| Dividend (1) | 26,010 | – | – | – | – |
| Capital gains, net | 35,797 | 5,346 | 23,610 | 2,579 | 5,715 |
| Others | (605) | (339) | (605) | (221) | 2,129 |
| | 54,055 | 130,654 | 23,005 | (22,088) | 109,386 |

(1) On May 14, 2006 the Company received the notice of Eurofund 2000 Partnership, a venture capital fund which invests mainly in start-ups in communications, software, internet, semiconductors and homeland security ("the Fund"), of a distribution, following the sale of the Fund's holdings (approximately 18%) in an optical network equipment company for approximately US \$42 million (the Fund had invested \$2 million in the company). As a result of the distribution, the Company recorded a gain from the dividend of approximately NIS 26 million.

Notes to the Financial Statements as at September 30, 2006

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. STATEMENTS OF OPERATIONS

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|--|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues (Note 12B) | 3,509,098 | 3,566,204 | 1,177,398 | 1,211,014 | 4,723,734 |
| Costs and expenses | | | | | |
| Operating and general expenses (Note 12C) | 1,744,496 | 1,733,455 | 575,900 | 604,220 | 2,346,451 |
| Depreciation | 958,561 | 1,047,889 | 315,356 | 347,411 | 1,390,435 |
| Royalties to the Government of Israel* | 40,993 | 104,021 | 15,828 | 33,915 | 135,575 |
| | 2,744,050 | 2,885,365 | 907,084 | 985,546 | 3,872,461 |
| Operating income | 765,048 | 680,839 | 270,314 | 225,468 | 851,273 |
| Financing income (expenses), net | (28,866) | (28,448) | (3,642) | 2,575 | (80,897) |
| Earnings after financing expenses | 736,182 | 652,391 | 266,672 | 228,043 | 770,376 |
| Other income, net | 64,772 | 200,855 | 24,179 | 1,455 | 201,012 |
| Earnings before income tax | 800,954 | 853,246 | 290,851 | 229,498 | 971,388 |
| Income tax | 250,294 | 298,087 | 97,840 | 99,399 | 332,118 |
| Earnings after income tax | 550,660 | 555,159 | 193,011 | 130,099 | 639,270 |
| Company's equity in earnings (losses) of investee companies | 149,908 | (23,000) | 51,979 | (26,950) | (63,412) |
| Earnings before the cumulative effect of change in accounting principle | 700,568 | 532,159 | 244,990 | 103,149 | 575,858 |
| Cumulative effect of change in accounting principle as at the beginning of the year | - | 15,000 | - | - | 15,000 |
| Net earnings | 700,568 | 547,159 | 244,990 | 103,149 | 590,858 |

* See Note 7A(9).

Notes to the Financial Statements as at September 30, 2006

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. REVENUES FROM TELECOMMUNICATION SERVICES

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|--|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Fixed-line domestic communications- | | | | | |
| Traffic | 1,030,610 | 1,121,254 | 346,205 | 377,184 | 1,460,076 |
| Fixed fees | 1,833,966 | 1,797,867 | 619,879 | 607,442 | 2,404,970 |
| Total revenues from fixed-line communications | 2,864,576 | 2,919,121 | 966,084 | 984,626 | 3,865,046 |
| Cellular telephone | 280,205 | 280,050 | 94,301 | 94,584 | 370,706 |
| International communications | 87,352 | 82,476 | 29,177 | 28,498 | 109,207 |
| Installation and sale of equipment to subscribers and miscellaneous | 139,217 | 120,205 | 44,367 | 45,931 | 167,904 |
| | 3,371,350 | 3,401,852 | 1,133,929 | 1,153,639 | 4,512,863 |
| Other income | 137,748 | 164,352 | 43,469 | 57,375 | 210,871 |
| | 3,509,098 | 3,566,204 | 1,177,398 | 1,211,014 | 4,723,734 |

C. OPERATING AND GENERAL EXPENSES

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|---|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and related expenses – | | | | | |
| Operations | 863,636 | 834,499 | 282,295 | 282,128 | 1,140,482 |
| General and administrative | 237,169 | 207,445 | 76,960 | 70,672 | 288,804 |
| Total salaries and incidental expenses | 1,100,805 | 1,041,944 | 359,255 | 352,800 | 1,429,286 |
| General expenses | 193,814 | 232,556 | 63,441 | 78,522 | 298,767 |
| Materials and spare parts | 57,734 | 60,812 | 15,455 | 22,437 | 97,294 |
| Building maintenance | 233,446 | 236,342 | 82,172 | 83,254 | 320,700 |
| Services and maintenance by sub- contractors | 143,568 | 157,623 | 49,384 | 54,636 | 195,820 |
| International communications expenses | 19,199 | 22,478 | 5,890 | 12,603 | 30,033 |
| Vehicle maintenance expenses | 103,552 | 94,378 | 36,664 | 36,971 | 128,961 |
| Collection fees | 27,300 | 27,868 | 8,569 | 9,630 | 36,735 |
| | 1,879,418 | 1,874,001 | 620,830 | 650,853 | 2,537,596 |
| Less – salaries charged to investments in fixed assets | 134,922 | 140,546 | 44,930 | 46,633 | 191,145 |
| | 1,744,496 | 1,733,455 | 575,900 | 604,220 | 2,346,451 |

Notes to the Financial Statements as at September 30, 2006

NOTE 13 – BUSINESS SEGMENTS

The Company and the investee companies operate in various segments of the communications sector. Data on activities by segment are stated according to the segments of operation of those companies.

| | For the nine-month period ended September 30, 2006 (unaudited) | | | | | | Consolidated |
|--------------------------------|--|--------------------|--|--------------------------|--------------|-------------|------------------|
| | Domestic fixed-line communications | Cellular telephone | International communications and Internet services | Multi-channel television | Others | Adjustments | |
| | NIS thousands | | | | | | |
| Revenues | | | | | | | |
| Revenues from external sources | 3,295,732 | 3,317,991 | 745,582 | 996,758 | 170,468 | – | 8,526,531 |
| Inter-segment revenues | 213,366 | 12,023 | 15,903 | 12,645 | 73,293 | (327,230) | – |
| Total revenues | 3,509,098 | 3,330,014 | 761,485 | 1,009,403 | 243,761 | (327,230) | 8,526,531 |
| Segment results* | 765,048 | 457,710 | 102,121 | (35,642) | 9,223 | – | 1,298,460 |

| | For the nine-month period ended September 30, 2005 (unaudited) | | | | | | Consolidated |
|--------------------------------|--|--------------------|--|--------------------------|----------------|-------------|------------------|
| | Domestic fixed-line communications | Cellular telephone | International communications and Internet services | Multi-channel television | Others | Adjustments | |
| | NIS thousands | | | | | | |
| Revenues | | | | | | | |
| Revenues from external sources | 3,365,414 | 3,343,524 | 587,946 | 881,003 | 161,330 | – | 8,339,217 |
| Inter-segment revenues | 200,790 | 10,797 | 16,186 | 14,583 | 89,564 | (331,920) | – |
| Total revenues | 3,566,204 | 3,354,321 | 604,132 | 895,586 | 250,894 | (331,920) | 8,339,217 |
| Segment results* | 680,839 | 384,045 | 68,922 | (78,763) | (1,659) | – | 1,053,384 |

* Segment results do not include Other income (expenses), net, as stated in Note 11.

Notes to the Financial Statements as at September 30, 2006

NOTE 13 – BUSINESS SEGMENTS (CONTD.)

For the three-month period ended September 30, 2006 (unaudited)

| | Domestic fixed-line communications | Cellular telephone | International communications and Internet services | Multi- channel television | Others | Adjustments | Consolidated |
|--------------------------------|--|-----------------------|---|---------------------------------|--------------|-------------|----------------|
| | NIS thousands | | | | | | |
| Revenues | | | | | | | |
| Revenues from external sources | 1,105,131 | 1,139,846 | 253,763 | 336,120 | 46,544 | – | 2,881,404 |
| Inter-segment revenues | 72,267 | 4,472 | 5,974 | 3,660 | 25,618 | (111,991) | – |
| Total revenues | 1,177,398 | 1,144,318 | 259,737 | 339,780 | 72,162 | (111,991) | 2,881,404 |
| Segment results* | 270,314 | 163,472 | 33,072 | (18,609) | 3,273 | – | 451,522 |

For the three-month period ended September 30, 2005 (unaudited)

| | Domestic fixed-line communications | Cellular telephone | International communicatio ns and Internet services | Multi- channel television | Others | Adjustments | Consolidated |
|--------------------------------|--|-----------------------|--|---------------------------------|----------------|-------------|----------------|
| | NIS thousands | | | | | | |
| Revenues | | | | | | | |
| Revenues from external sources | 1,144,535 | 1,139,297 | 195,157 | 304,867 | 54,863 | – | 2,838,719 |
| Inter-segment revenues | 66,479 | 3,232 | 6,432 | 5,786 | 28,747 | (110,676) | – |
| Total revenues | 1,211,014 | 1,142,529 | 201,589 | 310,653 | 83,610 | (110,676) | 2,838,719 |
| Segment results* | 225,468 | 129,725 | 26,038 | (28,970) | (2,235) | – | 350,026 |

For the year ended December 31, 2005 (unaudited)

| | Domestic fixed-line communications | Cellular telephone | International communicatio ns and Internet services | Multi- channel television | Others | Adjustments | Consolidated |
|--------------------------------|--|-----------------------|--|---------------------------------|--------------|-------------|------------------|
| | NIS thousands | | | | | | |
| Revenues | | | | | | | |
| Revenues from external sources | 4,457,189 | 4,413,421 | 795,176 | 1,200,865 | 232,035 | – | 11,098,686 |
| Inter-segment revenues | 266,545 | 14,854 | 21,488 | 20,997 | 104,511 | (428,395) | – |
| Total revenues | 4,723,734 | 4,428,275 | 816,664 | 1,221,862 | 336,546 | (428,395) | 11,098,686 |
| Segment results* | 851,273 | 466,165 | 97,978 | (99,535) | 1,197 | – | 1,317,078 |

* Segment results do not include Other income (expenses), net, as stated in Note 11.

Notes to the Financial Statements as at September 30, 2006

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD.**

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheets

| | September 30 2006 | September 30 2005 | December 31 2005 |
|---|------------------------------|------------------------------|-----------------------------|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | 1,506,905 | 1,882,739 | 1,881,982 |
| Long-term trade receivables | 319,916 | 339,872 | 338,281 |
| Investment in shares and in an investee partnership | 4,923 | 3,216 | 3,565 |
| Deferred taxes | – | 33,322 | 19,799 |
| Fixed assets, net | 2,752,163 | 3,029,525 | 3,009,219 |
| Other assets, net | 360,052 | 336,925 | 337,787 |
| | 4,943,959 | 5,625,599 | 5,590,633 |
| Current liabilities | 1,226,841 | 1,571,287 | 1,558,012 |
| Long-term liabilities | 1,491,105 | 1,721,223 | 1,666,193 |
| Shareholders' equity | 2,226,013 | 2,333,089 | 2,366,428 |
| | 4,943,959 | 5,625,599 | 5,590,633 |

Notes to the Financial Statements as at September 30, 2006

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)**

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. Statements of Operations

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|---|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues from Pelephone services and sales | 3,330,016 | 3,354,322 | 1,144,321 | 1,142,530 | 4,428,277 |
| Cost of Pelephone services and sales | 2,480,310 | 2,557,693 | 844,745 | 871,563 | 3,415,885 |
| Gross profit | 849,706 | 796,629 | 299,576 | 270,967 | 1,012,392 |
| Sales and marketing expenses | 309,300 | 330,155 | 108,249 | 114,983 | 432,808 |
| General and administrative expenses | 73,879 | 76,232 | 27,855 | 26,264 | 107,218 |
| | 383,179 | 406,387 | 136,104 | 141,247 | 540,026 |
| Operating income | 466,527 | 390,242 | 163,472 | 129,720 | 472,366 |
| Financing expenses, net | 54,349 | 82,277 | 12,496 | 42,829 | 115,264 |
| Other expenses (income), net | 4,921 | (497) | 2,736 | (390) | (1,136) |
| Earnings before income tax | 407,257 | 308,462 | 148,240 | 87,281 | 358,238 |
| Income tax | 117,672 | 96,855 | 51,188 | 23,860 | 113,333 |
| Earnings after income tax | 289,585 | 211,607 | 97,052 | 63,421 | 244,905 |
| Company's equity in losses of company and investee partnership, net | - | (8,548) | - | (2,140) | (8,507) |
| Net earnings | 289,585 | 203,059 | 97,052 | 61,281 | 236,398 |

Notes to the Financial Statements as at September 30, 2006

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD.

A. Balance sheets

| | September 30 2006 | September 30 2005 | December 31 2005 |
|--------------------------|----------------------|----------------------|---------------------|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | 165,576 | 142,114 | 154,567 |
| Broadcasting rights, net | 177,925 | 161,339 | 154,500 |
| Fixed assets, net | 965,203 | 1,071,672 | 1,047,994 |
| | 1,308,704 | 1,375,125 | 1,357,061 |
| Current liabilities | 746,085 | 617,877 | 613,379 |
| Long-term liabilities | 1,377,839 | 1,376,272 | 1,419,257 |
| Loans from shareholders | 3,000,000 | 2,850,274 | 2,893,024 |
| Capital deficit | (3,815,220) | (3,469,298) | (3,568,599) |
| | 1,308,704 | 1,375,125 | 1,357,061 |

B. Statements of Operations

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|-------------------------------------|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues from DBS services | 1,009,396 | 895,585 | 339,774 | 310,652 | 1,221,863 |
| DBS operating expenses | 873,936 | 799,940 | 298,283 | 276,143 | 1,089,835 |
| Gross profit | 135,460 | 95,645 | 41,491 | 34,509 | 132,028 |
| Sales and marketing expenses | 89,442 | 107,282 | 30,340 | 40,575 | 140,665 |
| General and administrative expenses | 71,863 | 57,640 | 26,334 | 19,650 | 77,055 |
| | 161,305 | 164,922 | 56,674 | 60,225 | 217,720 |
| Operating loss | 25,845 | 69,277 | 15,183 | 25,716 | 85,692 |
| Financing expenses, net | 191,026 | 174,064 | 61,928 | 73,263 | 241,335 |
| Other expenses, net | 904 | 568 | 702 | 480 | 830 |
| Net loss | 217,775 | 243,909 | 77,813 | 99,459 | 327,857 |

Notes to the Financial Statements as at September 30, 2006

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. Balance sheets

| | September 30 2006 | September 30 2005 | December 31 2005 |
|--|----------------------|----------------------|---------------------|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | 306,947 | 320,208 | 366,078 |
| Long-term investments and debit balances | 41,098 | 28,619 | 28,702 |
| Fixed assets | 313,071 | 317,273 | 305,826 |
| Other assets | 21,086 | 23,930 | 23,625 |
| | <u>682,202</u> | <u>690,030</u> | <u>724,231</u> |
| Current liabilities | 328,690 | 218,317 | 401,126 |
| Long-term liabilities | 25,693 | 186,269 | 14,835 |
| Shareholders' equity | 327,819 | 285,444 | 308,270 |
| | <u>682,202</u> | <u>690,030</u> | <u>724,231</u> |

Notes to the Financial Statements as at September 30, 2006

**NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)**

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. Statements of Operations

| | For the nine-month period ended September 30 | | For the three-month period ended September 30 | | For the year ended December 31 |
|--|---|-------------|--|-------------|-----------------------------------|
| | 2006 | 2005 | 2006 | 2005 | 2005 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Revenues from international telecommunication services | 761,485 | 604,132 | 259,736 | 201,589 | 816,664 |
| Operating expenses | 498,674 | 394,064 | 171,846 | 127,592 | 530,806 |
| Gross profit | 262,811 | 210,068 | 87,890 | 73,997 | 285,858 |
| Marketing expenses | 109,868 | 98,351 | 38,006 | 35,899 | 135,736 |
| General and administrative expenses | 50,822 | 42,795 | 16,811 | 12,060 | 57,561 |
| Operating income | 102,121 | 68,922 | 33,073 | 26,038 | 92,561 |
| Financing income (expenses), net | 1,985 | (3,388) | 1,462 | 175 | (3,361) |
| Earnings after financing, net | 104,106 | 65,534 | 34,535 | 26,213 | 89,200 |
| Other income (expenses), net | 2,031 | 63 | 2,226 | 17 | 1,377 |
| Earnings before income tax | 106,137 | 65,597 | 36,761 | 26,230 | 90,577 |
| Tax benefit (Income tax) | (33,342) | 17,678 | (11,491) | 7,700 | 15,226 |
| Earnings after income tax | 72,795 | 83,275 | 25,270 | 33,930 | 105,803 |
| Company's equity in earnings of an affiliated company | 6,902 | 2,940 | 2,889 | 1,643 | 4,583 |
| Net earnings | 79,697 | 86,215 | 28,159 | 35,573 | 110,386 |