May 3, 2005

"Bezeq" The Israel Telecommunication Corp. Limited

Quarterly Report for the period ending 31.3.05

Update of Chapter A (Description of Company Operations) of the Periodic Report for 2004

Directors' Report on the State of the Company's Affairs for the period ended March 31, 2005

Condensed Interim Consolidated Financial Statements as at March 31, 2005

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)[1] OF THE PERIODIC REPORT FOR 2004 ("THE PERIODIC REPORT") OF "BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

1. DESCRIPTION OF GENERAL DEVELOPMENT OF GROUP OPERATIONS

Section 1.1 – Group Activity and Description of its Business Development

Section 1.1.5 of the Periodic Report in the matter of the merger of the Company and the subsidiary D.B.S. Satellite Services (1998) Ltd. ("DBS"), notes that the Company applied to the Jerusalem District Court for a declaratory decision determining that the decisions of the Ministers of Communications which limited the Company's injections into DBS were issued *ultra vires* and are therefore void. On March 20, 2005 the District Court ruled that the competent court for hearing the case is the High Court of Justice, and accordingly, it transferred the proceeding to that venue. Subsequently, on April 17, 2005, the Company filed, in the Supreme Court, an application for leave to appeal the decision of the District Court and an application to convert the claim – if the application for leave to appeal is dismissed – to a petition to the High Court of Justice.

It is noted that DBS also filed a petition in the High Court of Justice on the same matter.

On the matter of the conditional approval of the Antitrust Commissioner for the merger, on March 14, 2005 the Company and DBS filed appeals against the conditions for the merger. The cable companies filed an application to join the proceedings and the Company and DBS filed oppositions to that application. On March 15, 2005, the cable companies also filed an appeal of their own against approval of the merger, and the Company and DBS filed applications for dismissal of that appeal *in limine*.

For a detailed description of developments in this matter, see Note 4 to the financial statements of the Company for the period ended March 31, 2005.

Section 1.3 – Investments in Equity and Stock Transactions

Further to Sections 1.3.4 and 2.20 of the Periodic Report on the matter of the privatization of the Company, to the best of the knowledge of the Company, the groups participating in the proceeding are expected, on May 9, 2005, to submit their offers for purchase of 30% of the Company's share capital and an option to acquire another 10.66% of the share capital of the Company from the State of Israel.

It is noted that on April 6, 2005 the Company's bylaws were amended so as to clarify, beyond any doubt, that after another person receives advance written approval for control of the Company in accordance with the provisions of the Communications Law and the Communications Order, and he takes control of the Company, whether alone or together with others, including with the State under an agreement with it, certain provisions (those similar to provisions from the Government Company Law) in the Company's bylaws will be canceled, and the majority required for electing directors will be changed from 60% to 50%.

Section 1.4 – Distribution of Dividends

Further to Section 1.4.4 of the Periodic Report in the matter of an undertaking by the buyer of the controlling interest in the Company to act by virtue of his holdings in relation to distribution, it was clarified to the participants in the privatization proceeding by the Director General of the Government Companies Authority, in a letter dated April 19, 2005, that the position of the Government Companies Authority is that no restrictions will be imposed on the buyer of the controlling interest preventing him from initiating and implementing a distribution with the approval of a court in accordance with Section 303 of the Companies Law, 5759-1999 (reduction of capital). In addition, the Company received a copy of a letter which was sent to the Director General of the Government Companies Authority on April 17, 2005 by the Chairman of the Company Workers Organization, in which the Chairman of the

[1] The update is pursuant to Article 39A of the Securities Regulations (Periodic and immediate repots), 5730-1970, and includes material changes or innovations that have occurred in the corporation in any matter which must be described in the Periodic Report. The update relates to several sections from Chapter A (Description of Company Operations) in the Company's Periodic report for 2004.

organization informs the participants that the Company Workers Organization sees a distribution pursuant to Section 303 of the Companies Law as contrary to the arrangements with the Company employees and that any attempt to reduce the capital will meet the strong opposition of the employees.

2. FIXED-LINE DOMESTIC COMMUNICATIONS – BEZEQ, THE ISRAEL TELECOMMUNICATION CORP. LIMITED ("THE COMPANY")

Section 2.2 – Products and Services

In the matter of Section 2.2.2 of the Periodic Report – Telephony - on April 21, 2005 the Company received a letter from the Director General of the Ministry of Communications, stating that after examining the various considerations and data submitted to the Ministry, the Minister of Communications is considering refusing her approval (contrary to the approval in principle given to the Company by the former Minister) to cease the provisions of the Bezeqcard service. The Company has been requested to submit its remarks on this letter by May 10, 2005, and intends to oppose the possible change in the Ministry's position, as it has already made preparations for terminating the service based on the approval in principle it was given previously.

In the matter of Section 2.2.3 of the Periodic Report – Internet access services, as at March 31, 2005, the Company's ADSL subscribers number approximately 709,000 (compared with about 650,000 subscribers at the end of 2004).

Section 2.6 – Competition

a. **Ministry of Communications document – Clarification for participants in the privatization proceeding of the Company**

On April 6, 2005 a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the participants in the privatization proceeding of the Company. The document contains explanations of the main questions raised by the participants in the privatization proceeding, based on the present policy of the Ministry of Communications for promoting competition in communications and provisions of the law and existing licenses, and notes that these explanations should not set any expectation or be relied upon by the participants.

The main points of the clarifications in the document appear in an immediate report of the Company dated April 11, 2005. As the Company noted in that report, it believes that the clarifications in the Ministry of Communications Clarification Document do not significantly reduce the regulatory uncertainty in which the Group and the Company operate. Furthermore, the document contains general explanations about future operations regarding which the Company is unable to make any assessment at this stage as to when or if they will occur, and therefore the Company is unable to assess their implications for the operations of the Company and the subsidiaries of the Group and on the results of those operations.

On this matter, see also Note 1C(1) to the financial statements of the Company for the period ended March 31, 2005.

b. **Interconnect fees**

On the matter of the arrangement whereby interconnect fees will not be paid for terminating a call between the networks of the Company and the cable companies ("HOT") described in Section 2.6.1 of the Periodic report – on April 14, 2005 the Company has withdrawn its petition to the High Court of Justice. On this matter, see also Note 1C(4) to the financial statements of the Company for the period ended March 31, 2005.

c. **VOB service policy**

Further to Section 2.6.1 of the Periodic Report, on April 20, 2005 the Ministry of Communications notified, *inter alia*, the Company and its subsidiaries that in completing preparation of the policy and following study of the remarks submitted in response to their enquiries, it is considering amendment of the policy paper so that the Company or a subsidiary of the Company will be able to provide VOB services after the Company's market share in fixed-line domestic telephony in a particular customer segment falls below 85%. In addition, the Ministry of Communications intends to set two review dates, in November 2006 and November 2007, to look into the possibility of permitting the Company or a subsidiary of the Company to provide VOB services even if the Company has not lost 15% of that market share, noting the developments in competition in the field of telephony.

The Ministry of Communications requested remarks on the above by May 10, 2005. The Company sees the aforementioned amendment as possible deterioration for itself and from the aspect of its subsidiaries, and has notified the Ministry that the amendment it is considering as set out above is contrary to the policy paper and that it intends to submit its opposition in the future. See also the update to Section 4.5 below.

d. **Marketing trial for payment for VOIP services**

On the matter of licenses for a marketing trial for payment for VOIP services as described in Section 2.6.1 of the Periodic Report – after a joint discussion at the Ministry of Communications with the Company and the operators who wish to offer this service, the Ministry of Communications issued an administrative instruction for the operation of dialing directions and numbering ranges allocated for the use of a licensee for a marketing trial in the Company's network. In an additional letter from the Ministry of Communications, it was clarified that the Company will not bear "expenses in kind" of the trial, and that if additional payment is determined as part of the VOB policy, that payment will apply retroactively also for the trial period. As at the date of publication of these reports, the Company is in touch with the trial licensees for connecting them to the Company's network.

e. **Numbering and number portability**

Further to Section 2.6.5 of the Periodic Report, on March 29, 2005 the Economic Policy for Fiscal 2005 Law (Legislative amendments), 5765-2004 was passed by the Knesset. The law includes, among other things, an amendment of the Communications Law (Telecommunications and broadcasting), 5742-1982 ("the Communications Law"), whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006. (If the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone, in an order and with the approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months.)

On April 20, 2005 the Ministry of Communications sent to the licensees a draft numbering plan which it is considering for implementation and operation, for their remarks by May 18, 2005. The draft sets out milestones at which the licensee must have installed and operated all the means required for the application of number portability in its systems no later than January 31, 2006, will commence interconnect tests no later than February 1, 2006 and complete them no later than June 1, 2006, and will provide number portability to whoever requests it no later than August 1, 2006. The Company is preparing its remarks to the Ministry of Communications on the proposed draft program.

As the Company noted in an immediate report on March 23, 2005, the implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. Similar investment will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. In addition, operation of number portability involves costs relating to joint recording and management with the relevant operators, the full extent of which cannot yet be assessed. Even though the date for the implementation of number portability has been extended beyond the date originally proposed in the Bill (February 2006), and with which the Company commented that it believes it will be unable to comply, it will nevertheless be difficult for the Company to ready itself for number portability even by the date approved by the Committee (even if extended to the end of 2006). In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the Company's ability to compete.

f. **<u>The Company's commitments with business customers</u>**

Further to Section 2.6.6G of the Periodic Report – on March 28, 2005 the High Court of Justice decided to leave in place the interim order for staying cancellation of the agreements between the Company and business customers until the hearing of the petition is heard on July 4, 2005. However, the Court also determined in its decision that there is no impediment to the Ministry of Communications calling NIS 8 million of the bank guarantee out of the guarantee given to the Ministry by the Company. As at the date of publication of this report, the Ministry of Communications has not taken any action relating to foreclosure of the guarantee.

Section 2.9 – Human Resources

a. **<u>Labor dispute and its subsequent clarification on the matter of the retirement of the remaining transferred employees by 2011</u>**

As reported by the Company on April 5, 2005 and April 14, 2005 in its immediate reports, on April 5, 2005 the Company received notice of a possible strike at the Company starting on April 21, 2005 ("the Labor Dispute"). After talks between the Government Companies Authority, the Company and the workers' representatives which ended on April 13, 2005 in an exchange of letters among the parties, the Labor Dispute was brought to an end. The main points in the correspondence were these:

"(1) It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the employees' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which states that 'Immediately after signing this Agreement, the parties will start intensive negotiations to arrange the retirement of the remaining transferred employees by 2011 on the one hand, and the demands of the Company's Management for organizational and other changes on the other hand.”

(2) The Government Companies Authority clarified that, if after sale of the State's holdings in the Company an agreement as referred to above is made, no additional approvals will be required from the Government Companies Authority and the Supervisor of Wages at the Ministry of Finance, for extension of the validity of the retirement agreement. The Government Companies Authority also clarified that to the extent its approval is required for the agreement, the sale of the State's holdings will replace the approval.

(3) The correspondence will be presented to the participants in the proceeding for the sale of the State's holdings in the Company."

In the opinion of the Company, the above will not change the existing agreements. Furthermore, the aforementioned clarification will not influence the financial statements of the Company. To the best of the Company's knowledge, the correspondence was shown to the participants in the proceeding for the sale of the State's holdings in the Company.

b. In the matter of a one-time bonus to Company employees in the amount of half of the amount of the salary reduction in accordance with the Plan for Recovery of the Israeli Economy Law and a collective agreement for encouraging economic growth in respect of the period from August 28, 2004 to the date of transfer of the State's holdings to the buyer of the controlling interest in the Company – see Note 1D to the financials statements of the Company for the period ended March 31, 2005.

Section 2.13 – Finance

a. **<u>Section 2.13.4 – Credit received after December 31, 2004</u>**

On April 4, 2005 the Company completed an issue, by way of a private placement to institutional investors, NIS 286,967,000 par value debentures (Series 5). The proceeds from the issuance amounted to NIS 315,663,700, where the purchase price for NIS 1 par value is 110 points and reflects a yield of 4.46% (the Company received the proceeds on April 4, 2005). The debentures were listed for trading on the Tel Aviv Stock Exchange and their terms are the same as those of the debentures from the same series which are in circulation (registered debentures, repayable in six equal annual installments in each of the years 2100 to 2016, bearing interest of 5.3% p.a. and not secured by any lien).

b. **Section 2.13.6 – Credit rating**

1. Moody's rating for eurobonds – On March 7, 2005 the rating outlook was changed from A3 (Stable) to A3 (Negative). The change reflects the uncertainty arising from the expected continuation of the privatization of the Company and the possibility that the new holder of control at the Company (after the privatization is completed) will change the financial strategy of the Company. See the Company's immediate report dated March 8, 2005.

2. Midroog rating for debentures series (4) and (5) – On March 24, 2005 the rating outlook was changed from Aa1 (Watch List) to Aa1 (Negative). The negative rating outlook was given because of the process of sale of the controlling interest in the Company and in light of the possible implications of the transfer of control from the State to private hands. See the Company's immediate reports dated March 27, 2005 and March 28, 2005.

3. Maalot rating for all series of the Company's debentures – On March 28, 2005 a rating of AA was given (no change in the rating). See the Company's immediate report of March 28, 2005 for details of the main considerations for the rating.

It is noted that the above ratings of Midroog and Maalot were made ahead of the private placement described in sub-section A. above.

Section 2.14 – Taxation

On taxation, see Note 2B to the financial statements of the Company for the period ended March 31, 2005.

Section 2.15 – Environmental protection

a. On the matter of the Non-Ionized Radiation Bill distributed by the Ministry of the Environment – the revised version of the Bill – the transitional period has been extended from nine months to one year.

b. On the matter of permits for communications installations under the Planning and Construction law – see the update to Section 2.16 (sub-section E.) below.

Section 2.16 – Limitation and regulation of Company activities

a. On the clarifications by the Ministry of Communications to the participants in the privatization proceeding of the Company, and on number portability – see the update to Section 2.6 above.

b. Further to Section 2.16.1 of the Periodic Report concerning the regulation of Company tariffs, and Section 2.16.3 concerning royalties – on March 29, 2005 the Knesset approved the amendments to the Communications Law described in those sections, as part of the Economic Policy Bill.

c. Further to Section 2.16.2 of the Periodic Report concerning the main points of the amended license/tariffs – Following the Company's notice of its intention to demand the participation in payment of a commission by subscribers who pay through the Postal Bank, the Ministry of Communications announced that it is considering amendment of the Company's license so that it will determine that the Company must enable a range of means of payment of its bills, including through the Postal Bank. The Ministry of Communications also stated that its position is that the Company may not collect such a commission. The Company responded that the proposed amendment of the license and the position of the Ministry of the matter are beyond its authority and unreasonable. The Company is currently in discussions with the Ministry of this matter.

d. Further to Section 2.16.3 of the Periodic Report concerning royalties – On May 2, 2005 the Company received a copy of a letter dated April 20, 2005, sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties. According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the proceeding for sale of the State's holdings in the Company and as part of the preparations for the implementation of number portability service throughout the telecommunications sector, the Telecommunications Regulations (Royalties) will be amended by the Ministries and brought for the approval of the Minister of Communications, the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until reaching a rate of 1% in 2010.

e. Further to Section 2.16.10B of the Periodic Report concerning permits for communications installations under the Planning and Construction Law, including permits from the Supervisor of Radiation – in view of the intensive activity at the Company to obtain the permits, and in the light of interruption of the operations of certain installations, several sites and their classification change from time to time. As at the date of publication of these reports, there has been no material change in the overall volume of the installations.

Section 2.17 – Material agreements

a. Further to Section 2.17.2 (concerning a deed of trust for debentures (series 5) dated May 24, 2004 and an addendum to that deed dated December 6, 2005) – on March 30, 2005 an additional addendum to the deed of trust was signed between the Company and the Nominees Company of Mizrachi Bank Ltd. in respect of an issue of NIS 286,967,000 par value debentures from the same series. See the update to Section 2.13 above and the Company's immediate report dated March 30, 2005.

b. Further to Section 2.17.7 –

   (1) On April 17, 2005 a special collective agreement was signed between the Company, the Workers Committee and the Histadrut, concerning an arrangement with an alternative entity to the Makefet Fund for everything relating to early retirement arrangements for Company employees. On this matter, see also Note 5A to the financial statements of the Company for the period ended March 31, 2005.

   (2) On May 3, 2005 a special collective agreement was signed between the Company, the workers representatives and the Histadrut in the matter of payment of a one-time bonus in the amount of part of the sum of the salary reduction pursuant to the Plan for the Economic Recovery of Israel Law and a collective agreement to encourage growth in the economy, as described in the update of Section 2.9 (sub-section b) above.

Section 2.18 – Legal proceedings

For updates on the subject of legal proceedings, see Notes 6A(1) to 6A(6) to the financial statements of the Company for the period ended March 31, 2005.

Section 2.20 – Event or matter outside the normal course of business

On the proceeding for privatization of the Company, see the update to Section 1.3 above.

3. CELLULAR – PELEPHONE COMMUNICATIONS LTD. ("PELEPHONE")

Section 3.7 – Competition

On the matter of number portability, see the update of Section 2.6(e) above. Implementation of the number portability plan will impose implementation costs and complexities on Pelephone, the scope and implications of which cannot yet be assessed.

Section 3.18 – Restriction and supervision of Pelephone's actions

a. Further to the matter of number portability – see the update of Section 3.7 above.

b. Further to Section 3.18.2 concerning supervised tariffs – in partial compensation for reduction of the tariffs described in that section, on March 1, 2005 Pelephone raised the outgoing call tariff from the Pelephone network and on May 3, 2005 it raised the SMS tariff for outgoing messages from the Pelephone network.

Section 3.19 – Legal proceedings

For updates on legal proceedings, see Note 6A(5) and 6A(8) to the financials statements of the Company for the period ended March 31, 2005.

4. INTERNATIONAL COMMUNICATIONS AND INTERNET SERVICES – BEZEQ INTERNATIONAL LTD. ("BEZEQ INTERNATIONAL")

Section 4.1 – General

Further to Section 4.1.2.2 of the Periodic Report concerning royalties – see the update of Section 2.16 above concerning a letter of the Director General of the Ministry of Communications and the Deputy Director of Budgets at the Ministry of Finance dated April 20, 2005, in the matter of the expected gradual reduction in the percentage of royalties.

Section 4.4 – New products

New products launched in 2005:

a. Hosted Exchange services – A managed e-mail service. The service is based on a model of providing remote managed solutions on the broadband infrastructure, which reduces a business's costs compared with the alternative of purchasing a server and licenses.

b. Mobile Max services – This service enables convenient use of dialing from abroad to Israel from compatible cellular handsets, using a Bezeq International phone card.

c. Call Back service – A phone card service from abroad to Israel which reverses the direction of the call (Israel – abroad), thereby reducing costs.

Section 4.6 – Competition

On April 20, 2005 the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the licensing of the provision of telephony services by means of broadband access (VOB – Voice Over Broadband)), in a way that will prevent Bezeq International (as a subsidiary of the Company) from providing VOB services until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and November 2007. This policy amendment, if adopted, is liable to oust Bezeq International from this developing market, thereby awarding its competitors in Internet access and international dialing services (most of which have received marketing trial licenses from the Ministry of Communications for providing these services) a clear competitive advantage in that they will be able to offer their customers a total communications solution combining access to the Internet, international telephony and fixed-line domestic telephony services. The inability of Bezeq International to offer a similar solution is liable to cause its existing customers to leave in favor of the competitors' services and to make it difficult for Bezeq International to recruit new customers. Bezeq International is unable to estimate, at this stage, the effects of the above on the results of its operations and its financial condition. On this matter, see also the update of Section 2.6 above.

Implementation of the numbering plan and number portability (as detailed in the update of Section 2.6 (sub-section E) above, is liable to compel Bezeq International to make additional investments in infrastructure and equipment. Bezeq International is unable to estimate, at this stage, the total scope of such investments.

Section 4.17 – Restriction and supervision of Bezeq International's operations

Further to Section 4.17.1.3 of the Periodic Report concerning royalties – see the update of Sections 2.16 and 4.1 above.

Section 4.19 – Legal proceedings

a. With regard to the claim of an equipment supplier which was filed on November 24, 1998 in the Tel Aviv District Court against Bezeq International and the Company, as described in Section 4.19.1 of the Periodic Report, the Court recommended to the parties, in a pre-trial hearing on March 2, 2005, to make a further attempt at mediation and to notify it of their decision. At this stage, Bezeq International is awaiting receipt of the position of the plaintiff on the matter. The case is scheduled for the hearing of evidence and oral summations on September 11 and 20, 2005.

b. With regard to the claim filed on April 4, 2004 in the Jerusalem District Court by a competing international communications operator, as described in Section 4.19.2 of the Periodic Report, a pre-trial hearing of the action was held on April 10, 2005, in which the Court recommended that the parties apply for a mediation proceeding. The plaintiff and the State of Israel consented to the mediation proceeding. On April 17, 2005 Bezeq International and the Company gave notice that they do not agree to a mediation proceeding. Another pre-trial hearing is scheduled for September 2005.

c. With regard to the claim filed on January 2, 2005 in the Tel Aviv District Court by persons alleging to be the inventors and patentees of a prepaid telephone system, as described in Section 4.19.3 of the Periodic Report, on April 20, 2005 Alcatel Telecom Israel Ltd. ("Alcatel") notified the legal advisers of Bezeq International that it intends to take over the management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), subject to a number of qualifications; it is doing so pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel replaced Tadiran for the matter of this agreement). The matter of transfer of management of the defense has not yet been finally agreed between Bezeq International and Alcatel's lawyers. At the request of the defendants, the date for filing the statement of defense has been set at May 15, 2005. As at the date of the financial statements, no statement of defense has been filed on behalf of Bezeq International.

For additional updates on legal proceedings, see Note 6A(7) to the financial statements of the Company for the period ended March 31, 2005.

Section 4.21 – Risk factors

a. Section 4.21(e) – Anchor countries – concerning a commitment made by Bezeq International in its official price list to the lowest prices in four countries (USA, Russia, France and Argentina) until the end of 2005, and consequently the possible adverse effect on the revenues of Bezeq International if the price lists of its competitors are revised to below Bezeq International's prices – during the first quarter of 2005 the tariff to these four countries was revised from 44 agorot per minute to 29 agorot per minute.

b. Additional risk factor – International communication cables – The laying of a gas pipe along the shores of Israel by Israel Electric Corporation is liable to damage the underwater communications cable system which is the main artery of Israel's international communications. The matter is being handled by the Ministries of Communications and Infrastructures. Med Nautilus, the company responsible for most of Bezeq International's underwater communications cable system, announced that its network is properly backed up and secured, including the marine connection relating to the gas pipe. In view of the aforesaid, Bezeq International assesses the risk level as low.

5. MULTI-CHANNEL TELEVISION – D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS")

Section 5.6 – Competition

Further to Section 5.6.4 concerning positive and negative factors in competition – in the opinion of DBS the feasibility (including from engineering and economic aspects) of the advanced services, including video on demand, is possible by means of using a broadband infrastructure, but DBS has not yet received approval to provide these services commercially and the Ministry of Communications has announced that it believes such service would require legislative amendment. It is noted that video on demand service was launched recently by the cable companies for their digital service subscribers.

Section 5.9 – Human resources

Further to Section 5.9.1 of the Periodic Report – Organizational structure – as at the date of this report, the organizational structure of DBS has been changed so that DBS now consists of only eight divisions (rather than 10), after unification of the sales and marketing divisions and unification of the customer service and technical service divisions to form the customer service department.

Section 5.12 – Finance

On the matter of the financing of DBS's activities and the need to recruit additional sources of finance for it – in view of the position of the Ministry of Communications (see the update of Section 1.1 above), and without derogating from DBS's contentions in relation to that position, DBS is actively seeking alternative sources of financing for implementing its business plan (beyond bank credit). In March 2005 and April 2005 DBS entered into agreements with institutional bodies for receipt of NIS 50 million in long-term CPI-linked loans bearing 11% interest p.a., on inferior repayment terms compared with the bank credit except for similar exception to those applicable to the shareholders' loans which the shareholders of DBS have made available and will make available after April 1, 2004. To secure repayment of the loans to the institutional bodies, the Company made a commitment (which is contingent, *inter alia*, on a positive value of DBS), and the banks which are financing the operations of DBS agreed that in the event of realization of the Company's shares in DBS by them, the institutional bodies would be entitled to a proportional part of the proceeds, at the percentage determined in the agreements. The institutional bodies were also given an option to extent loans in the same amount as already extended, provided that the amounts of the loans are required according to the business plan of DBS. Concurrently with these agreements, appropriate amendments were also signed in the financing agreement with the banks which are financing the operations of DBS, which are mainly viewing the loans received from the institutional bodies as if they were shareholders' loans as aforesaid.

On this matter, see also Note 4 to the financial statements of the Company for the period ended March 31, 2005.

Section 5.14 – Restrictions and supervision of the corporation

Further to Section 5.14.1 of the Periodic Report, Specific legal restrictions on operations – according to a decision of the Council for Cable Broadcasts and Satellite Broadcasts ("the Council") in 2003, DBS had met the obligation to invest in local productions except for the sum of NIS 2,500 thousand and under-investment of NIS 6,000 thousand in original quality productions, but the Council allowed DBS to make up these shortfalls during 2004 and 2005. DBS notified the Council that it had met its local production obligations for 2004 (including the proportional part of completing past obligations), and the matter is currently being examined by the Council. For 2006 onwards, no decision has been made as yet with regard to the percentage of DBS's revenues that will be invested in local productions (according to the Communications Law, that percentage should be between 8% and 12% of the revenues), but the Communications Law states that increasing the percentage of the investment in local productions required of DBS necessitates a hearing for DBS by the Council, and DBS is unaware of any plans for such a hearing.

Further to Section 5.14.2 of the Periodic Report – subordination of operations to the broadcasting license – According to a decision of the Supreme Court on March 22, 2005, in High Court of Justice 7200/02 filed by DBS against the Council and others, beyond the authority of the Minister of Communications for amendment of the broadcasting license of DBS (in consultation with the Council), the Council alone may also modify the terms of the broadcasting license, provided that before doing so, it gave the licensee the opportunity for a fair hearing.

Section 5.15 – Material agreements

Further to Section 5.15.5 of the periodic report – Finance agreement with the banks – see the update of Section 5.12 above.

Section 5.17 – Legal proceedings

Further to Section 5.17.3 of the Periodic Report – on March 20, 2005 the Jerusalem District Court determined that the authority to hear the claim filed by the Company against the decision of the Minister of Communications dated December 31, 2004 and the decision of the Minister of Communications dated February 14, 2005, is that of the High Court of Justice (see the update of section 1.1 above). Subsequently, on April 7, 2005, DBS filed a petition on the same matter in the High Court of Justice, which has not yet been heard.

Date	"Bezeq" The Israel Telecommunication Corp. Limited

Names and titles of signatories:

Dalit Braun, Member of the Board (Chairperson of the approval meeting)
Amnon Dick, CEO

May 3, 2005

Directors' Report on the State of the Company's Affairs for the period ended March 31, 2005

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies are hereinafter collectively referred to as "the Group") for the three-month period ended March 31, 2005 (hereinafter: "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, 2004.

The Group operates in four 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**

Below is information detailing the financial statements which were fully consolidated in the Report Period and which were not included in the corresponding period last year:

1. Pelephone Communications Ltd. – full consolidation since August 26, 2004 (until that date, 50% proportional consolidation).

2. D.B.S. Satellite Services (1998) Ltd. – full consolidation since June 21, 2004.

1. Financial Position

A. The Group's assets as at March 31, 2005 amounted to approximately NIS 20.36 billion, compared with NIS 15.86 billion as at March 31, 2004. Of these, approximately NIS 10.50 billion (approximately 52%) are fixed assets, compared with approximately NIS 8.50 billion (approximately 54%) on March 31, 2004. NIS 3.27 billion of the increase in total assets originates from first-time consolidation.

In the fixed-line domestic communications segment there was a decrease in the net book value of the fixed assets resulting from the difference between depreciation expenses and the investment made in the Report Period. There was also a decrease in cash balances and short-term investments compared with the prior year.

In the cellular segment there were additional investments in fixed assets and an increase in trade receivables and inventory, which contributed to the increase in total assets.

In the international communications and internet services segment there was an increase in total assets compared with the prior year, mainly due to a rise in the cash and trade receivable balances. Conversely, total investments in fixed assets decreased in this segment compared with last year.

In the multi-channel television segment total assets increased compared with last year, mainly due to a rise in content rights and in the customer credit balance.

B. The Group's shareholders' equity as at March 31, 2005 amounted to approximately NIS 7.75 billion, comprising approximately 38% of the total balance sheet, compared with approximately NIS 7.01 billion on March 31, 2004, which comprised approximately 44% of the total balance sheet. The increase in shareholder' equity derived from the Group's net earnings accumulated since the end of the corresponding period last year.

C. Total Group debt to financial institutions and debenture holders as at March 31, 2005 amounted to approximately NIS 8.54 billion, compared with approximately NIS 5.21 billion on March 31, 2004. Approximately NIS 2.5 billion of the increase derives from the first-time consolidation and the remainder from the receipt of loans and an offering of debentures to the public and institutional investors by the Company and Pelephone.

D. Group balances in cash and short-term investments as at March 31, 2005 amounted to approximately NIS 3.13 billion compared with approximately NIS 3.18 billion on March 31, 2004. The decrease derives mainly from exercise of the option to purchase the second half of the shares of Pelephone. The decrease was offset by the cash flow from current operations in the main segments of the Group's business and also from an issuance of debentures and receipt of loans.

2. Results of Operations

A. Principal results

Net earnings for the three-month period ended March 31, 2005, amounted to approximately NIS 280 million, compared with net earnings of approximately NIS 168 million in the corresponding period of the prior year. The difference in the results derives mainly from the Other income (expenses) item, where an expense of approximately NIS 30 million (before tax) was recorded in the corresponding period mainly in connection with early retirement costs and in the reported period revenues of approximately NIS 88 million (before tax) were recorded, mainly a capital gain of about NIS 104 million. In addition, the reported period includes a cumulative effect as at the beginning of the year of the change in the accounting method relating to recognition of a deferred tax asset of NIS 25 million (see Note 2B to the financial statements).
The increase in net earnings was offset by a decrease in operating income and a rise in the financing expenses of the Group.

Below are details of the changes in the results of the segments in comparison with the previous year (not including other revenues/expenses, net).

	For the three-month period ended March 31	
Segment	**2005 NIS millions**	**2004 NIS millions**
Fixed-line domestic communications	249	296
Cellular[(1)]	121	67
International communications and internet services	21	34
Multi-channel television[(2)]	(26)	–
Others	–	2

Earnings per share in the first three months of 2005 amounted to NIS 0.107 per NIS 1 par value, compared with earnings of NIS 0.064 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in the first three months of 2005 amounted to approximately NIS 2.77 billion, compared with approximately NIS 2.01 billion in the corresponding period in the prior

(1) First-time full consolidation.
(2) First-time consolidation.

year. The increase of approximately NIS 811 million derives from first-time consolidation. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 1.27 billion in the first three months of 2004 to approximately NIS 1.2 billion in the reported period (a decrease of approximately 5.5%). Most of the decrease in the segment's revenues derives from tariff reductions in June 2004, a decrease in call and internet dial-up traffic and a decrease in revenues from the sale of equipment to subscribers. The decrease in revenues was moderated by the ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL) and by a settlement agreement with a controlling customer (see Note 7B to the financial statements). The auditors drew attention to the ongoing opening of the communications industry to competition and to expected tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 535 million in the first three months of 2004 to approximately NIS 1.11 billion in the reported period, mainly as a result of the effect of the first-time full consolidation implemented during 2004. In addition, the segment's revenues increased as a result of the increase in the number of customers by about 48 thousand in the quarter, the increase in revenues from sales of handsets to customers and from the sale of repair service packages. Amendment to the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1, 2005 slowed the upward trend in the segment's revenues. In partial compensation for the reduction in those tariffs, Pelephone increased the outgoing call tariff for some of its customers.

Revenues from the international communications and internet services segment increased from approximately NIS 198 million in the first three months of 2004 to approximately NIS 199 million in the reported period. The segment's revenues increased mainly as a result of the increase in internet revenues which derived from the growth in the number of ADSL customers, the sale of internet access service capacity, growth in international call routing traffic and an increase in data service revenues. The growth was offset mainly by a decrease in traffic and in outgoing call tariffs, and a decrease in internet access service tariffs.

Revenues of approximately NIS 289 million from the multi-channel television segment were included in the Group's revenues for the first three months of 2005, with the first-time consolidation of DBS during 2004. There has been an increase in revenues in this segment compared with the corresponding period as a result of the increase of about 12.7 thousand subscribers in the quarter and in average revenue per subscriber.

C. General and Operating Expenses

The Group’s general and operating expenses in the first three months of 2005 amounted to approximately NIS 1.76 billion, compared with approximately NIS 1.09 billion in the corresponding period of the prior year. Approximately NIS 622 million derives from first-time consolidation.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 554 million in the first three months of 2004 to approximately NIS 562 million in the reported period (an increase of about 1%). Most of the increase is attributable to the rise in building maintenance expenses as a result of an agreement in which the Company received a refund of municipal taxes in the corresponding period in the prior year.

In the cellular segment the increase in expenses from approximately NIS 401 million in the first three months of 2004 to approximately NIS 839 in the reported period, arises mainly from the first-time full consolidation. In addition, expenses in the segment increased compared with the corresponding period mainly due to the increase in revenues and in the costs of subscriber acquisition, which derives from winning the tender of the Accountant General at the Ministry of Finance.

In the international communications and internet services segment there was an increase in expenses from approximately NIS 132 million in the first three months of 2004 to approximately NIS 152 million in the reported period, as a result of the increase in expenses for foreign managers deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator.

General and operating expenses of approximately NIS 235 million from the multi-channel television segment were included in the Group's expenses for the first three months of 2005, due to the first-time consolidation of DBS during 2004.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 472 in the first three months of 2004 to approximately NIS 578 million in the current period, as a result of first-time consolidation in respect of which depreciation expenses increased by about NIS 135 million. Eliminating this increase, depreciation expenses decreased as a result of the full depreciation of fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment.

E. Royalties to the Government of Israel

The Group's royalties expense amounted to approximately NIS 66 million, compared with approximately NIS 47 million in the corresponding period in the prior year. The source of the increase is the first-time consolidation referred to above.

F. Operating income

The Group's operating income amounted to approximately NIS 366 million, compared with approximately NIS 399 million in the corresponding period in the prior year, a decrease of approximately NIS 33 million. The decrease in operating income derives from the changes in the results of the segments described above in the revenues and expenses sections. These changes led to a fall in the profitability of the Group's main segments of operation (except for the multi-channel television segment). The decrease in the Group's operating income was partially decreased due to the first-time consolidation of DBS, as described above.

G. Financing expenses

The Group's net financing expenses amounted to approximately NIS 55 million, compared with approximately NIS 31 million in the corresponding period in the prior year. The source of approximately NIS 41 million of the expenses is the first-time consolidation.
These finance expenses are influenced by changes in interest rates, exchange rates and the Index.
In the fixed-line domestic communication segment, financing expenses decreased compared with the prior year due to changes in the CPI and in the exchange rates of the dollar and the euro. The effect of the changes in the foreign currency and shekel rates was largely neutralized by carrying out hedging transactions and investment in financial assets.
In the cellular segment, financing expenses were lowered, *inter alia*, by recycling loans at lower interest rates and as a result of the negative inflation in the quarter.

H. Other income (expenses)

Income amounting to approximately NIS 88 million was recorded in the Group's Other income (expenses) item, compared with an expense of approximately NIS 30 million in the corresponding period of the prior year. Most of the expense in the corresponding period was an increase in the provision for early retirement. The income recorded in the reported period derived mainly from capital gains of approximately NIS 104 million. This income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 10 the financial statements).

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates decreased compared with corresponding period in the prior year, from approximately NIS 65 million in 2003 to approximately NIS 3 million in the reported period. Most of the decrease derived from the change of DBS into a consolidated company towards the end of the first half of the prior year, and the results of its operations are presented in the financial statements on a consolidated basis rather than by the equity method (see Note 4 to the financial statements).

The Company's auditors drew attention to the financial condition of DBS and to the fact that its continued operation is contingent upon further receipt of loans from the shareholders (or other alternative financing), including loans from the Company, in accordance with the DBS's work plan.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities amounted to approximately NIS 628 million, compared with approximately NIS 758 million in the corresponding period in the prior year. Eliminating an increase of approximately NIS 83 deriving from first-time consolidation, cash flows from operating activities decreased by approximately NIS 213 million. In the fixed-line domestic communications and cellular segments this was mainly as a result of changes in the assets and liabilities items. In addition, operating income in the fixed-line domestic communications segment also decreased, also contributing to the decrease in cash flows from operating activities.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the reported period included, *inter alia*, approximately NIS 476 million in the development of communications infrastructure and approximately NIS 275 million in short-term investments.

During the period the Group repaid approximately NIS 683 million in debts, of which approximately NIS 592 million was on account of long-term loans and approximately NIS 91 million on account of debentures. The Group raised new debt in a total amount of approximately NIS 940 million by an offering of debentures, receipt of new long-term loans and receipt of short-term bank credit.

The average monthly short-term credit during the period was approximately NIS 96 million. The average monthly long-term liabilities for the period was approximately NIS 8,333 million.

Working capital as at March 31, 2005 is positive and amounted to approximately NIS 1,254 million, compared with positive working capital of approximately NIS 1,490 million on March 31, 2004. The decrease derives mainly from the first-time consolidation, which reduced working capital by approximately NIS 398 million, mainly from the multi-channel television segment, and from a reduction of approximately NIS 395 million in the working capital of the fixed-line domestic communications segment. Conversely, working capital increased in the cellular segment, mainly as a result of raising long-term debt and the repayment of short-term loans.

4. Group involvement in the community and donations

In the reported period the Company was active in the community through its involvement in social institutions and organizations such as the education system in distressed areas and the confrontation line.
To mark the twentieth anniversary of its establishment, the Company made donations to various organizations during the 12 months commencing February 20, 2004. The amount of the monthly donation was the higher of 5% of its call revenues on the twentieth day of each month of its anniversary year or NIS 200 thousand. In the reported period the Company donated NIS 231 thousand, and overall throughout the campaign, a total of NIS 2,792 thousand.

5. Details concerning market risk exposure and management thereof

A. Further to the description in the Directors' Report for 2004, as a result of hedging transactions against market risks relating to exposure to changes in exchange rates, the Group incurred no material financing expenses or income in the reported period.

B. The report of positions of derivatives as at March 31, 2005 is not significantly different from the report as at December 31, 2004.

C. The report on linkage bases as at March 31, 2005 is not significantly different from the report as at December 31, 2004.

Surplus monetary liabilities over monetary assets denominated in or linked to a foreign currency as at March 31, 2005 amounted to approximately NIS 3 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at March 31, 2005 amounts to approximately NIS 131 million.
Surplus monetary liabilities over monetary assets linked to the CPI as at March 31, 2005 amount to approximately NIS 3.8 billion in the Group.

6. Utilization of proceeds from securities

An offer for sale and an issuance to the public pursuant to a prospectus was published on May 24, 2004. The application of proceeds from the offering will be decided by the Company from time to time, in accordance with its requirements, including, taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements there has been no need to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

7. Miscellaneous

a. **Adoption of a code of ethics**

On April 20, 2005 the Board of Directors of the Company adopted a code of ethics formulated by the Company for business conduct. The code of ethics sets out principles and rules of behavior for guiding the activities of Company officers, managers and employees. The Vice President for Management Resources was appointed compliance officer for the implementation of the provisions of the code of ethics.

b. **Chairman of the Board**

Commencing March 7, 2005, the Company has no acting Chairman. In accordance with the Company's Articles of Association, a chairman is appointed for each meeting of the Board of Directors.

Dalit Braun **Member of the Board** **(Chairperson of the approval meeting)**	**Amnon Dick** **CEO**

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED)

Contents

The Board of Directors of
"Bezeq" - The Israel Telecommunications Corp. Limited

Dear Sirs,

Re: Review of the Unaudited Condensed Interim Consolidated Financial Statements as at March 31, 2005

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunications Corp. Limited (hereinafter "Company") as at March 31, 2005, 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 three-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 March 31, 2005, constitute approximately 36% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 59% 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 70 million as at March 31, 2005, and the Company’s share in the losses in respect thereof amount to approximately NIS 3 million for the three-month period 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.

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 5.

3. Contingent claims made against the Company and against invested companies, as described in Note 6A.

4. The financial position of a subsidiary including:

   a. Restriction imposed by the Ministry of Communications on the Company in connection with additional cash injections into the subsidiary.

   b. The resolution of the Company's Board of Directors of February 17, 2005, pursuant to which the Board stands by its resolution of March 30, 2004 to continue investing in the subsidiary according to the approved work plan, together with other shareholders and financial bodies.

   As described in Note 4, the continuation of the Subsidiary's activities is dependent upon continuing to receive additional loans from shareholders, including loans from the Company and loans from additional lenders in accordance with the Subsidiary's work plan

Somekh Chaikin
Certified Public Accountants (Isr.)

May 3, 2005

Condensed Interim Consolidated Balance Sheets as at

Reported amounts

	March 31 2005 (Unaudited)	March 31 2004 (Unaudited)	December 31 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	**1,549,873**	2,118,243	1,457,107
Short-term investments	**1,577,274**	1,063,489	1,287,809
Trade receivables	**2,099,986**	1,757,541	2,115,070
Other receivables and debit balances	**487,696**	390,895	416,113
Inventory	**304,441**	98,149	314,549
	6,019,270	5,428,317	5,590,648
Materials and spare parts	**137,309**	155,817	130,922
Broadcasting rights, net	**150,617**	-	140,496
Investments and long-term receivables			
Investments, deposits and debit balances	**887,189**	774,108	872,575
Investments in investee companies	**69,933**	225,917	70,308
	957,122	1,000,025	942,883
Fixed assets			
Cost	**34,632,903**	28,625,327	34,311,281
Less– accumulated depreciation	**24,128,266**	20,127,320	23,570,947
	10,504,637	8,498,007	10,740,334
Other assets			
Goodwill	**1,769,379**	–	1,792,658
Deferred charges and other assets	**387,007**	246,770	387,904
Deferred taxes	**438,686**	528,677	446,136
	2,595,072	775,447	2,626,698
	20,364,027	15,857,613	20,171,981

	March 31 2005 (Unaudited)	March 31 2004 (Unaudited)	December 31 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current liabilities			
Bank credit	**103,561**	69,639	88,102
Current maturities of:			
Long-term bank loans	**918,637**	867,751	1,304,916
Debentures	**302,914**	173,314	240,481
Trade payables	**1,375,675**	1,050,675	1,675,569
Employee severance benefits	**634,337**	549,506	592,474
Other current liabilities	**1,429,857**	1,226,980	1,402,140
	4,764,981	3,937,865	5,303,682
Long-term liabilities			
Long-term loans	**2,813,357**	1,549,754	2,860,934
Debentures	**4,398,407**	2,547,884	3,824,539
Employee severance benefits	**612,947**	773,206	680,096
Other long-term liabilities	**30,038**	35,877	47,375
Loans extended by the minority in a consolidated company:			
Loans	**1,064,057**	–	1,057,988
Less – minority share in deficit of a consolidated company	**(1,064,057)**	–	(1,057,988)
	7,854,749	4,906,721	7,412,944
Minority rights	**(1,177)**	163	(10,412)
Contingent liabilities (Note 6)			
Shareholders' equity	**7,745,474**	7,012,864	7,465,767
	20,364,027	15,857,613	20,171,981

Dalit Braun Member of the Board (Chairperson of the approval meeting)	**Amnon Dick** Chief Executive Officer	**Ron Eilon** Chief Financial Officer

Date of approval of the financial statements: May 3, 2005

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

Condensed Interim Consolidated Statements of Operations

Reported amounts

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenues from telecommunications services (Note 8)	**2,773,123**	2,009,221	9,269,804
Costs and expenses			
General and operating expenses (Note 9)	**1,763,851**	1,090,812	5,565,090
Depreciation	**577,507**	471,792	2,092,475
Royalties to the Government of Israel	**65,552**	47,372	220,691
	2,406,910	1,609,976	7,878,256
Operating income	**366,213**	399,245	1,391,548
Financing expenses, net	**(54,876)**	(30,749)	(217,529)
Earnings after financing expenses	**311,337**	368,496	1,174,019
Other income (expenses), net (Note 10)	**87,614**	(30,452)	79,680
Earnings before income tax	**398,951**	338,044	1,253,699
Income tax	**(132,870)**	(105,314)	(497,485)
Earnings after income tax	**266,081**	232,730	756,214
Equity in losses of affiliates	**(3,321)**	(64,884)	(134,773)
Minority share in losses (earnings) of consolidated companies	**1,947**	76	(616)
Earnings before the cumulative effect of a change in accounting method	**264,707**	167,922	620,825
Cumulative effect of the a change in accounting method as at the beginning of the year*	**15,000**	–	–
Net earnings	**279,707**	167,922	620,825
Primary and diluted earnings per NIS 1 par value of common shares (in NIS):			
Earnings before the cumulative effect of a change in accounting method	**0.102**	0.064	0.238
Cumulative effect of a change in accounting method	**0.005**	–	–
Net earnings per share	**0.107**	0.064	0.238

* See Note 2B

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	Retained earnings (deficit)	Total
			NIS thousands		
Three months ended March 31, 2005					
Balance as at December 31, 2004 (audited)	**6,309,133**	**1,623,423**	**37,775**	**(504,564)**	**7,465,767**
Net earnings (unaudited)	–	–	–	**279,707**	**279,707**
Balance as at March 31, 2005 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**(224,857)**	**7,745,474**
Three months ended March 31, 2004					
Balance as at December 31, 2003 (audited)	6,309,133	1,623,423	37,775	(1,125,389)	6,844,942
Net earnings (unaudited)	–	–	–	167,922	167,922
Balance as at March 31, 2004 (unaudited)	6,309,133	1,623,423	37,775	(957,467)	7,012,864
Year ended December 31, 2004					
Balance as at December 31, 2003 (audited)	6,309,133	1,623,423	37,775	(1,125,389)	6,844,942
Net earnings (audited)	–	–	–	620,825	620,825
Balance as at December 31, 2004 (audited)	6,309,133	1,623,423	37,775	(504,564)	7,465,767

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

Condensed Interim Consolidated Statements of Cash Flows

Reported amounts

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Cash flows from operating activities			
Net earnings	**279,707**	167,922	620,825
Adjustments to reconcile net earnings to net cash flows from operating activities (see A below)	**347,992**	589,968	2,229,157
Net cash generated by operating activities	**627,699**	757,890	2,849,982
Cash flows from investing activities			
Investment in fixed assets	**(475,508)**	(397,243)	(1,650,557)
Proceeds from disposal of fixed assets and sale of operations	**12,568**	22,706	131,576
Investment in long-term deposits and investments	**-**	(16,173)	(42,064)
Realization of long-term deposits and investments	**6,318**	15,444	18,094
Decrease (increase) in short-term investments, net	**(275,089)**	260,167	135,602
Decrease (increase) in materials and spare parts	**(35,935)**	(49,282)	625
Acquisition of companies consolidated for the first time (see C below)	**-**	–	(246,935)
Investment in investee companies	**(2,628)**	(46,908)	(142,753)
Investment in other assets	**(23,760)**	(45,662)	(130,700)
Net cash used for investing activities	**(794,034)**	(256,951)	(1,927,112)
Cash flows from financing activities			
Issue of debentures (after deduction of issue expenses)	**812,295**	315,000	1,528,092
Repayment of other debentures	**(91,603)**	(516,035)	(601,481)
Receipt of long-term loans	**114,500**	72,026	314,900
Repayment of long-term loans	**(591,550)**	(132,962)	(2,605,012)
Receipt (repayment) of short-term bank credit, net	**15,459**	(75,075)	(56,612)
Net cash generated by (used for) financing activities	**259,101**	(337,046)	(1,420,113)
Increase (decrease) in cash and cash equivalents	**92,766**	163,893	(497,243)
Cash and cash equivalents at beginning of period	**1,457,107**	1,954,350	1,954,350
Cash and cash equivalents at end of period	**1,549,873**	2,118,243	1,457,107

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

Condensed Interim Consolidated Statements of Cash Flows (Contd.)

Reported amounts

	For the three-month period ended March 31		For the year ended December 31
	2005	2004	2004
	(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	**577,507**	471,792	2,092,475
Deferred taxes	**40,859**	–	–
Company's equity in losses of affiliated companies	**3,321**	(63,014)	219,975
Minority share in earnings (losses) of a consolidated company	**(1,947)**	64,884	134,773
Decrease in employee severance benefits, net	**(25,286)**	(76)	616
Loss (gain) from disposal of fixed assets	**(1,730)**	(50,717)	(110,334)
Provision for decrease in value of investments	**-**	80	(7,338)
Gain from sale of operations	**(101,860)**	–	(35,033)
Erosion (appreciation) and interest on long-term deposits and investments	**21,839**	(3,916)	26,000
Erosion (appreciation) of short-term investments, net	**(14,376)**	16,685	31,199
Appreciation (erosion) of long-term liabilities:			(10,584)
Debentures	**(84,391)**	(502)	115,674
Long-term loans and other liabilities	**25,489**	41,379	(17,104)
Amortization of other assets and deferred charges	**47,936**	20,107	110,083
Changes in asset and liability items:			
Increase in broadcasting rights	**(10,121)**		(17,516)
Decrease (increase) in trade receivables	**(8,270)**	(99,305)	52,827
Decrease (increase) in other receivables and debit balances	**(29,244)**	83,465	(8,223)
Decrease (increase) in inventory	**5,740**	(14,295)	(122,824)
Increase (decrease) in trade payables	**(142,772)**	53,122	(102,466)
Increase (decrease) in other current liabilities	**62,635**	82,351	(126,652)
Increase (decrease) in deferred revenues	**(17,337)**	(12,072)	3,609
	347,992	589,968	2,229,157
B– Non-cash transactions			
Acquisition of fixed assets, other assets, materials and spare parts on credit	**122,859**	92,624	102,687
Sale of fixed assets on credit	**131,408**	399	1,196
C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company			
Working capital (excluding cash and cash equivalents)			2,057,632
Fixed assets			(2,967,819)
Long-term liabilities			2,322,740
Minority loans to a consolidated company			1,048,637
Less minority share in the deficit			(1,048,637)
Minority rights			(16,549)
Investment in an affiliate			178,339
Goodwill			(1,821,278)
			(246,935)

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

NOTE 1 – GENERAL

A. These interim statements were prepared according to 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, 2004, and for the year then ended, and the accompanying notes thereto (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 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 field of cellular telephone services, international communication services, domestic communication services, multi-channel television services, the opening of these markets to competition, and decisions of the Ministerial Committee on Privatization relating to the sale of the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2004. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:

(1) On April 10, 2005 a copy of a letter of the Director General of the Ministry of Communications dated April 6, 2005 was forwarded to the Company. The letter is addressed to the Director of the Government Companies Authority and contains clarifications for the participants in the privatization proceeding of the Company. According to the letter, the explanations in it are in response to questions raised by the participants in the privatization proceeding and they are based on the present policy of the Ministry for the promotion of competition in the communications field and on the provisions of the law and the existing licenses, and they should not be seen as grounds for any expectation or reliance on the part of the participants. The clarifications relate, *inter alia*, to the following issues: the policy for licensing the provision of telephony services by means of VOB (Voice Over Broadband); the Company's tariffs and volume discounts; baskets of services; interconnect payments; royalties; structural separation; universal service; the Communications Order; the use of ADSL by the subsidiary DBS for providing its services; minimum payment for making a cellular call; fixed-mobile convergence, and number portability. In the opinion of the Company, the explanations in the letter of the Director General do not significantly reduce the regulatory uncertainty in which the Group and the Company operate. Furthermore, the letter also refers in a general way to future actions which the Company is unable to assess, at this stage, whether and when they will occur, and is therefore also unable to gauge their implications for the activities of the Company and the subsidiaries in the Group and for their financial results.

(2) Further to Note 1E(1)e. to the financial statements as at December 31, 2004 concerning a policy paper for "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator", on April 20, 2005 the Ministry of Communications informed, *inter alia*, the Company and its subsidiaries that in completing preparation of the policy and after examining the remarks submitted in response to their request, it was considering amending the policy paper so as to allow the Company or one of its subsidiaries to provide VOB services once the Company's market share in fixed-line domestic telephony to certain customer segments falls below 85%. In addition, the Ministry intends to set two review dates, in November 2006 and November 2007, to look into the possibility of permitting the Company or one of its subsidiaries to provide VOB services even if the Company has not lost 15% of its market share, noting the developments in competition in telephony. The Ministry has requested remarks on this proposal by May 10, 2005. The Company sees this aforementioned amendment as a possible deterioration of opportunities for itself and for its subsidiaries, and notified the Ministry of Communications that the amendment under consideration, as set out above, runs counter to the policy paper and that it intends to submit its opposition in the near future.

NOTE 1 – GENERAL (CONTD.)

C. (2) (contd.)

In addition, amendment of that policy, to the extent it is adopted, will prevent Bezeq International (as a subsidiary of the Company) from providing VOB services and could force Bezeq International out of this developing market, thereby granting its competitors in internet access services and international communication (most of which have received a marketing trial license from the Ministry of Communications for the provisions of these telephony services), a clear competitive advantage in that they will offer their customers a total communications solution that combines internet access, international telephony and fixed-line domestic services. In the opinion of Bezeq International, its inability to offer a similar total solution is liable to cause its existing customers to leave in favor of competitors' services and to make it difficult to recruit new customers. Bezeq International is unable to estimate, at this stage, the effects of the aforementioned on the results of its operations and its financial position.

(3) Regarding marketing trial licenses for payment for fixed-line services over the Internet (VOIP), after joint discussion at the Ministry of Communications with the Company and operators who wish to offer this service, the Ministry of Communications issued an administrative directive for the operation of dialing directions and number ranges allocated for the use of the trial marketing licensees on the Company's network. In an additional letter, the Ministry of Communications clarified that the Company will not bear "expenses in kind" of the trial and that if additional payment is determined as part of the VOB policy, that payment would apply retroactively also for the trial period. As at the date of publication of these financial statements, the Company is in contact with the holders of trial licenses for their connection to its network.

(4) Further to Note 1E(1)f. of the financial statements as at December 31, 2004 concerning the arrangement whereby interconnect fees will not be paid for terminating a call between the networks of the Company and a domestic operator ("Hot"), on April 14, 2005 the Company withdrew its appeal to the Supreme Court.

(5) Further to Note 1E(1)g. of the financial statements as at December 31, 2004 concerning number portability, on March 29, 2005 the Economic Policy for Fiscal 2005 Law (Legislative amendments), 5764-2004 was passed by the Knesset. The law includes, among other things, an amendment of the Communications Law (Telecommunications and broadcasting), 5742-1982, whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006 (if the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone the implementation and operation of the program by an order and with the approval of the Knesset Economics Committee, for a period not exceeding three months).

On April 20, 2005 the Ministry of Communications sent to the licensees a draft numbering plan which it is considering for implementation and operation, for their remarks by May 18, 2005. The draft sets out milestones by which the licensee must have installed and operated all the means required for the implementation of number portability in its systems no later than January 31, 2006, will commence interconnect tests no later than February 1, 2006 and complete them no later than June 1, 2006, and will provide number portability to whoever requests it no later than August 1, 2006. The Company is preparing its position on the proposed draft plan for submission to the Ministry.

NOTE 1 – GENERAL (CONTD.)

C. (2) (contd.)

The implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. Heavy investment will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. In addition, operation of number portability involves costs relating to joint recording and management with the relevant operators, the full extent of which cannot yet be assessed. Even though the date for the implementation of number portability has been extended beyond the date originally proposed in the Bill (which was February 2006), and with which the Company commented that it believes it will be unable to comply, it will nevertheless be difficult for the Company to ready itself for number portability even by the date approved by the Committee (even if extended to the end of 2006). In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the ability of the Company and other companies in the Group to compete.

6. Further to Note 1B to the financial statements of the Company as at December 31, 2004 in the matter of payment of royalties to the Government of Israel, on May 2, 2005 the Company received a copy of a letter dated April 20, 2005, sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties. According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the proceeding for sale of the State's holdings in the Company and as part of the preparations for the implementation of number portability service throughout the telecommunications sector, the Telecommunications Regulations (Royalties) will be amended by the Ministries and brought for the approval of the Minister of Communications., the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until reaching a rate of 1% in 2010.

D. The Supervisor of Wages and Employment Agreements and the Government Companies Authority notified the Company that subject to the continued full cooperation of the employees with the privatization proceeding, they will be willing to approve a collective agreement whereby the Company will pay its employees a one-time grant in the amount of half of the salary reduction pursuant to the Economic Plan Law and the collective agreement for encouraging growth in the economy, in respect of the period commencing August 28, 2004 until the date of transfer of the State's holdings to the buyer as set out in the sale procedure. The value of that grant for the period until March 31, 2005 is NIS 11 million. No provision was included for the grant in the financial statements, since the conditions for its payment have not yet been fulfilled.

E. 1. At the beginning of 2005 Bezeq Zahav Holdings Ltd. ("Bezeq Zahav"), a wholly-owned subsidiary of the Company, sold NIS 300 million par value debentures (Series 4) of the Company out of the NIS 400 million debentures (Series 4) it had purchased from the Company. The proceeds in respect of the sale, in the amount of NIS 323,750 thousand, were transferred to the Company by Bezeq Zahav as (partial) repayment of a loan which the Company extended to Bezeq Zahav for purchase of those debentures (Series 4).

NOTE 1 – GENERAL (CONTD.)

E. (contd.)

2. On April 4, 2005 the Company completed the issue, by way of a private placement to institutional investors, of NIS 286,967,000 par value of debentures (Series 5) of NIS 1 par value each. The debentures are registered in trust, are repayable in six equal annual payments in each of the years 2011 to 2016, bear annual interest of 5.3%, and are not secured by any lien. The proceeds from the issue, which amounted to NIS 315,663,700, were received on April 4, 2005. The purchase price for NIS 1 par value debentures (Series 5) was 110 points, which reflects an annual yield to maturity of 4.46%

3. On February 27, 2005 Pelephone issued NIS 500 million of debentures to institutional bodies by way of a private placement, bearing 4.4% interest. The debentures are repayable in twenty half-yearly payments of the principal and interest.
   The purpose of raising this debt is to diversify Pelephone's sources of credit and the repayment of loans which will fall due in the near future.

NOTE 2 – REPORTING POLICIES AND ACCOUNTING PRINCIPLES

A. GENERAL

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

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS

Accounting Standard No. 19 – Taxes on Income.
In July 2004 the IASB published Accounting Standard No. 19 – Taxes on Income (hereinafter – "the Standard"). The Standard determines that deferred tax liabilities in respect of all taxable temporary differences are to be recognized, except for a small number of exceptions. In addition, a deferred tax asset in respect of all deductible temporary differences, tax losses and unutilized tax benefits are to be recognized if taxable income is expected against which they can be utilized, except for a small number of exceptions. The new Standard applies to financial statements for periods commencing January 1, 2005. Adoption of the Standard was by way of the cumulative effect of a change in accounting method. The transition to Accounting Standard No. 19 incurred a one-time effect on earnings of NIS 15,000 thousand, which derived mainly from an increase in deferred tax assets in respect of buildings and land.

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:

	Consumer price index	**Exchange rate of the US dollar**	**Exchange rate of the euro**
	%	%	%
For the three-month period ended:			
March 31, 2005	**(0.596)**	**1.230**	**3.879**
March 31, 2004	(0.100)	3.403	0.039
For the year ended December 31, 2004	1.207	(1.621)	6.212

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

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. DBS has accumulated considerable losses and negative cash flows. The loss for 2004 amounted to approximately NIS 366 million and the loss for the three-month period ended March 31, 2005 amounted to approximately NIS 61 million. As a result of these losses, its capital deficit and working capital deficit as at March 31, 2005 amount to approximately NIS 3,244 million and NIS 477 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,535 million (nominal). The Company's equity in the accumulated losses of DBS is approximately NIS 1,329 million, of which approximately NIS 59 million was recorded in the reported period (DBS's losses for the period, net of new loans given by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 57 million.

On January 6, 2005 the Company's Board of Directors resolved that in view of the oppressive conditions on which the merger of the Company and DBS was made contingent (increasing the Company's holdings in DBS to more than 50%) by the Antitrust Commissioner (in which, *inter alia*, the Commissioner restricted the funds that could be injected by the Company into DBS so that for a period of nine months from the date of approval of the merger, they would not exceed the proportional part of the Company in the shares of DBS while the other part would be injected by other shareholders in DBS and institutional investors), the Company would delay, at this stage, the exercise of the options for shares it received from DBS in accordance with agreements signed between shareholders in DBS and DBS, so that its holdings in DBS would remain at approximately 49.8%. The Company and DBS each filed an appeal against the decision of the Commissioner to make authorization of the increase in the Company's holdings in DBS conditional. Concurrently, the cable companies appealed the decision of the Commissioner, as aforementioned, in which they request that the court not permit the Company to increase its holdings in DBS under any conditions. The cable companies also requested to join the appeals filed by the Company and DBS. The Company and DBS have filed an application to dismiss the appeal of the cable companies and opposing their application to join the appeals. A hearing of the application of the Company and DBS for dismissal *in limine* of the cable companies' appeal, has been scheduled for September 2005.

In a letter dated December 31, 2004, the then Minister of Communications notified the Company that based on the findings of an examination carried out and after hearing the arguments of the Company and DBS, he is instructing the Company concerning the restriction of the additional injection of NIS 440 million, which the Company had decided to transfer to DBS by the end of 2005 in accordance with the approved business plan ("the Additional Injection") to the following format:

a. The total amount of the additional injection will be limited to a maximum of NIS 350 million (rather than NIS 440 million).

b. With regard to the NIS 195 million of the additional funding already transferred by the Company to DBS, the Minister does not intend to take any additional action.

c. The balance of the sum, a maximum of NIS 155 million, will be transferred once every quarter in equal portions during 2005, on the following principles:

   (1) The Company's share in the aforementioned amount will not exceed 55% (i.e. a maximum of NIS 85.25 million).
   (2) The share of the other shareholders in DBS and of the banks or institutional bodies in the transfer of the balance will be not less than 45% (i.e. a minimum of NIS 69.75 million).

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

The Minister also stated in his letter that in order to allow time to reach financing agreements based on the principles he has set forth, and as an interim step, the Company may inject funds into DBS, out of its share, without a corresponding transfer from the other shareholders, banks and institutional bodies, provided that the required proportions of such a transfer are fully maintained, no later than on April 30, 2005, and that the Company may not provide a guarantee to the shareholders in DBS, the banks or institutional bodies, or make any other similar commitment, for securing their part in the additional injection or in credit provided by them to DBS.

Since a new Minister of Communications was appointed after the above decision, the Company delayed taking legal action and met with the new Minister with the intention of convincing her that the decision from December 31, 2004 is basically flawed.

The new Minister concluded that there was no justification for changing the former Minister's instructions. However, taking into consideration the arguments of the Company and DBS on the need for time to implement the directive, she agreed, in a letter dated February 14, 2005, to allow staggered implementation of the former Minister's decision in the following manner:

a. The Company will be able to inject up to 75% of the maximum amount (NIS 64 million) by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it has transferred by the date of the letter), provided that by the end of June 2005, the proportions of the transfer decided upon by the former Minister are fully maintained.

b. The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) in the period from July 1, 2005 to the end of 2005, provided that the proportions of the transfer are maintained as set out in the former Minister's letter.

In the opinion of the DBS and the Company, the significance of the instructions in the present Minister's letter is material harm to both DBS, and the Company as the principal shareholder in DBS.

On February 17, 2005 the Board of Directors of the Company resolved that it stands behind its resolution from March 2004 as amended in May 2004, to continue to invest the Additional Injection in DBS according to the approved work plan, together with the other shareholders and financial bodies. This resolution was based, *inter alia*, on an external legal opinion that the Minister of Communications does not have the authority to forbid injections of funds into DBS. On February 23, 2005 the Minister of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications will be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including considering calling in the bank guarantee. The Company applied to the District Court in Jerusalem for a declaratory order determining that the decisions of the Ministers of Communications, which limit the Company's transfers of funds to DBS, were given *ultra vires* and are therefore void. On March 20, 2005 the District Court ruled that the competent court for a decision on the matter is the Supreme Court, and it transferred the proceeding to that venue.
Accordingly, on April 17, 2005 the Company filed in the Supreme Court a formal petition on the matter, an application for leave to appeal the decision of the District Court, and an application to convert the claim – if the application for leave to appeal is dismissed – to a petition to the High Court of Justice. It should be noted that DBS also filed a petition (to which the cable companies were joined as respondents) in the Supreme Court on the same matter. No date has been set for the hearing.

The terms of the long-term loans which DBS received from certain banking corporations (hereinafter "the Banks"), the balance of which as at March 31, 2005 is NIS 1,275 million, impose various limitations (*inter alia*, limitations with regard to a lien on or sale of certain assets, a limitation on receipt of credit from other banks without prior approval, a limitation relating to the repayment of shareholders' loans and a requirement to comply with financial criteria – hereinafter "the Conditions"). As at March 31, 2005, DBS is in compliance with those conditions.

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

On March 16, 2005 DBS signed an agreement with an institutional body whereby that body will extend a loan of NIS 15 million to DBS on three dates:

(1) NIS 7.5 million on the date of signing the agreement. The loan was transferred to DBS on March 31, 2005.
(2) NIS 3.75 million on July 1, 2005.
(3) NIS 3.75 million on October 1, 2005.

The institutional body has an option for a period of 12 months from the date of signing the agreement, to extend an additional loan to DBS in the same amount and on the same terms, provided that the amount of the loan is requested in accordance with the business plan of DBS.
The loan is linked to the Index and bears 11% interest.
The loan is due for repayment, together with the interest and linkage differentials, by December 31, 2013, subject to repayment of part of the bank loans on the terms set out in the agreement.

Subsequent to the balance sheet date, DBS signed agreements with two other institutional bodies for receipt of loans of NIS 20 million and NIS 15 million in one payment on the same terms (including an option for additional loans on the same terms). As at the date of approval of the financial statements, DBS had received the above amounts.

As described in Note 6B below, the Company undertook, in connection with the abovementioned three loans, that, if by December 31, 2013 the loans are not repaid (in full or in part) or upon the existence of certain other conditions, the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differentials) and an amount computed according to a predetermined formula which takes into account the value of DBS at that time. It should be noted that these loans are not in compliance with some of the conditions and restrictions imposed by the Antitrust Commissioner and the Ministers of Communications as described above, and the Company and DBS have applied to the relevant courts in respect of those loans as described above.

As at March 31, 2005 the Company has injected NIS 256 million of the Additional Injection.

At a meeting of the shareholders of DBS on January 16, 2005, the representatives of two other shareholders announced that they intend to recommend to the appropriate organs of their companies that they participate in further injections to DBS of NIS 20 million and NIS 10 million, respectively.
These recommendations will be in a situation where DBS will also have resources from the other shareholders (including the Company) for executing its business plan and without the instituting of a legal proceeding requesting interim relief that could halt the process. From the date of that decision to the date of approval of these financial statements, the additional shareholders have transferred NIS 7 million to DBS, of which NIS 4 million relate to the aforementioned notice.

The continued operation of DBS is conditional upon continued receipt of additional loans from the shareholders, including loans from the Company and from other lenders in accordance with DBS's work plan.

Management of DBS and the Company believe that in view of the aforementioned decision of the Company to continue investing in DBS according to the work plan, together with other shareholders and financial bodies, the chances of arranging the financial resources required by DBS in the coming year are good.

NOTE 5 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

EARLY RETIREMENT PLAN

a. Further to Note 16D to the 2004 financial statements of the Company concerning the process for selecting an alternative to the Makefet Fund, it was decided in principle, in coordination with the employees' representatives, as at the date of the financial statements, to select an alternative to the Makefet Fund in connection with the early retirement arrangements. In addition, on April 17, 2005 a special collective agreement was signed between the Company and the employees' representatives and the Histadrut, enabling early retirement of employees through that alternative entity. Entry of the agreement into effect is dependent on a number of regulatory approvals.

b. Notice of a labor dispute sent by the employees' representatives on April 5, 2005 was canceled on April 13, 2005, after an exchange of letters among the Company, the employees representatives and the Government Companies Authority, the main points of which were:

"(1) It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the employees' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which states that 'immediately after signing this agreement, the parties will start intensive negotiations to arrange the retirement of the remaining transferred employees by 2011 on the one hand, and the demands of the Company's Management for organizational and other changes on the other hand.'

(2) The Government Companies Authority clarified that if after sale of the State's holdings in the Company an agreement as referred to above is made, no additional approvals will be required from the Government Companies Authority and the Supervisor of Wages at the Ministry of Finance, for extension of the validity of the retirement agreement. The Government Companies Authority also clarified that to the extent its approval is required for the agreement, the sale of the State's holdings will replace the approval.

(3) The correspondence will be presented to the participants in the proceeding for the sale of the State's holdings in the Company."

In the opinion of the Company, the above will not change the existing agreement. Furthermore, the aforementioned clarification does not have an effect on the financial statements of the Company. To the best of the Company's knowledge, the exchange of letters was presented to the participants in the proceeding for the sale of the State's holdings in the Company.

NOTE 6 – 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 financial statements of the Company as at December 31, 2004. No material changes in contingent liabilities have occurred up to the date of signing these financial statements, other than the following:

(1) Further to Note 19A(1) to the financial statements as at December 31, 2004 concerning a petition filed in the High Court of Justice by 128 senior employees who were/are employed under personal employment agreements, to set aside a decision of the National Labor Court which dismissed a claim for a 33% salary increment (corresponding to the salary increment given to members of the Knesset and senior civil servants), on May 2, 2005 the High Court of Justice dismissed the petition.

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(2) Further to Note 19A(2)a. to the financial statements as at December 31, 2004 concerning the investigation of the Antitrust Commissioner into suspected restrictive arrangements relating to the supply of large exchanges (public switching), and following the dismissal of the Company's petition to direct the Antitrust Authority to allow the Company a hearing, to submit security material to the Company and to refrain from issuing a determination according to Section 43 of the Antitrust Law, the Company filed a written argument as part of a hearing in the matter of the Antitrust Authority's intention to issue such a determination. At the same time, the Company and the Antitrust Authority are in contact in an effort to arrive at an agreed order instead of the issue of such a determination against the Company.

(3) Further to Note 19A(3) to the financial statements as at December 31, 2004 concerning the claim of a group of employees who were employed as non-permanent employees at the Ministry of Communications, on March 6, 2005 a partial decision was given in which the allegation of the plaintiffs concerning their status as "transferred employees" was dismissed, and the court stated its position that the partial decision should become final. The plaintiffs' lawyer is required to file their position by July 1, 2005.

(4) Further to Note 19A(5) to the financial statements as at December 31, 2004 concerning a number of claims in the matter of recognition of various salary components as pension components and recognition of various components for the determining salary for computing severance pay – the maximum exposure in respect of these claims could, on certain assumptions, reach approximately NIS 2.6 billion. However, in light of the two decisions, on the matter of administrative call duty component and the matter of the grossing up of tax component, as described in the aforementioned Note, the Company re-assessed the situation and relying on its external legal advisers, concluded that exposure amounting to approximately NIS 2.2 billion (out of the maximum exposure) is remote. From the remainder of the exposure, approximately NIS 392 million, in respect of claims concerning components, in respect of which the Company believes, relying on its external legal advisers, the risk cannot be assessed or that the Company's chances of success in these claims are good, the Company did not include a provision in its financial statements other than a provision of NIS 50 million in respect of the administrative call duty component (according to the formula determined in the decision on this matter) and in respect of a possible settlement in the claim referred to in Note 19A(5)c to the 2004 financial statements of the Company.

(5) Further to Note 19A(9) to the financial statements as at December 31, 2004 concerning dismissal of an application for approval of the claim as a class action against the Company and Pelephone, in which it was alleged that the maximum payment that could be collected from a Company subscriber calling a Pelephone subscriber was lower than the amount actually collected, no appeal was filed against the decision and the proceeding has ended.

(6) Further to Note 19A(23) to the financial statements as at December 31, 2004 concerning a class action in which it is alleged that the Company's charges and calculations for internet access in the "WOW Extra" and "WOW Summer 2004" campaigns constituted deception, fraud, unjust enrichment and overcharging, the Company's investigation revealed that the plaintiff was not overcharged and for official-technical reasons the charge was split into a charge and a credit. The Company must file its response by May 8, 2005. The case is being studied and the defense allegations are being prepared. At this stage, the chances of the defense in the case cannot be assessed, and therefore no provision has been included in the financial statements in respect of this claim.

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(7) Further to Note 19A(26) to the financial statements as at December 31, 2004 concerning a claim filed against Bezeq International by a systems vendor, a preliminary hearing was held on March 15, 2005 in which a proposal was made to transfer the case to an arbitration proceeding. The case was scheduled for memorandum, which was postponed in view of the ongoing contacts between the parties. The legal advisers of Bezeq International are unable to estimate the chances of the claim at this stage, and therefore Bezeq International decided not to include a provision in respect of the claim in the interim financial statements.

8) Further to Note 19A(28) to the financial statements as at December 31, 2004 concerning allegations of the plaintiffs that Pelephone's pre-paid service constitutes infringement of a patent of the suing company, a decision was recently given by the Registrar of Patents on the matter of revocation of the patent, stating that the patent is unworthy of registration. The date for filing an appeal against the decision of the Registrar of Patents has not yet elapsed.

B. SECURITIES, LIENS AND GUARANTEES

In connection with three loan agreements signed between DBS and institutional bodies in March-April 2005, in a total amount of NIS 50 million (as described in Note 4 above), the Company undertook that if by December 31, 2013 the loans (all or some of them) are not repaid, or if certain other conditions obtain, the lenders will be able to demand repayment of the lower of the amount of the loan balance (principal, interest and linkage differentials) and the amount calculated according to a predetermined formula which takes into account the value of DBS at that time.

C. COMMITMENTS

Further to Note 19B(7) to the financial statements as at December 31, 2004 concerning Pelephone having won a tender issued by the Accountant General at the Ministry of Finance (hereinafter – the AG) for the provision of cellular services to the various government ministries for a period of three years commencing April 2005, the cost of purchasing the subscribers in the AG transaction, in the amount of NIS 30 million for supplying subscriber equipment, was charged in this quarter to the statement of operations.

D. FORWARD TRANSACTIONS

Forward Currency Transactions – Hedging Transactions

Consolidated

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	NIS millions
Currency exchange contracts at predetermined interest rates	Euro	CPI-linked NIS	October 2005	29	28
Forward contracts at predetermined exchange rate (excluding premium/discount)	Dollar	NIS	December 2005	1,141	1,185
	Euro	NIS	March 2006	1,623	1,665
	CPI-linked NIS	NIS	January 2006	511	519

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

D. FORWARD TRANSACTIONS

Forward Currency Transactions – Transactions not meeting the criteria for classification as hedging for accounting purposes

	Purchased currency	Currency payable	Last repayment date	Scope of commitment
				NIS millions
Options purchased (Call)	Dollar	NIS	March 2006	146
Options purchased (Put)	Dollar	NIS	April 2005	(22)

NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27 to the financial statements as at December 31, 2004 concerning advanced negotiations with the Ministry of Defense in the matter of a new agreement for the provision of communication services – a new commercial agreement has been drafted between the Company and the Ministry of Defense in the name of the State of Israel, for the provision of communication services by the Company. The agreement was approved by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and requires the approval of the general meeting of the shareholders of the Company (by a special majority), as stipulated in the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001.

The main points of the agreement are as follows:

(1) The Company will provide the IDF with communication services at discount rates that differ from the Company's official tariffs for those services. The average weighted discount to which the IDF is entitled under the agreement, relating to the annual scope of services consumed by the IDF prior to February 2004 (based on annual call data charged in the invoice from March 2003 up to and including the invoice for February 2004 and on a total fixed payment computed according to the inventory of lines existing in February 2004) is approximately 51.16%.

(2) The term of the contract is four years, retroactive from October 1, 2004, until September 30, 2008.

(3) The Company is guaranteed annual revenues of at least NIS 53.5 million (including VAT) for each of the first three years of the commitment, and at least NIS 52 million (including VAT) for the fourth year of the commitment.

(4) The standard of service laid down in the agreement is superior to that provided to other business customers, mainly from the aspect of shorter timetables for operational orders.

(5) The agreement ends and exhausts all the disputes between the parties up to the date of its execution, except for the following matters: (a) demands and/or claims of either party in connection with accounting made according to the previous framework agreement between the parties, dated July 21, 2002; (b) the parties' obligations according to the settlement agreement in relation to the transaction in section B below; (c) the parties' obligations according to an agreement reached between them on the matter of interest on late payments under the previous framework agreement.

NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

A (Contd.)

(6) The Company's obligation to invest in the development of infrastructures outside IDF bases, which will be required for providing the telecommunication services of the Company for the IDF, is limited to an amount of up to NIS 4.1 million (including VAT) per year of the agreement.

B. Further to Note 27B to the financial statements as at December 31, 2004 concerning a claim filed by the Company against the Ministry of Defense for payment of amounts in connection with a dispute on the matter of a discount of 18% which the Ministry of Defense deducted from payments collected by the Company for other communication suppliers, in April 2005 a settlement agreement was signed and was approved by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005. The settlement agreement requires the approval of the general meeting of the shareholders of the Company (by a special majority) in accordance with the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. Thereafter, the agreement will be filed for approval by the court.

The main points of the settlement agreement are as follows:

(1) To settle a financial claim for approximately NIS 37.4 million (principal) plus interest in an amount estimated at about NIS 20 million, which was filed by the Company against the State in the matter of the deduction of discounts of 18% on various charges included under the "Miscellaneous" section in the telephone bills of the IDF, the Ministry of Defense will pay a total of NIS 28.5 million (including VAT if applicable), in three equal installments of NIS 9.5 million each, which will be paid by the following dates: June 30, 2005, January 31, 2006 and June 30, 2006.

(2) Arrears in any of the payments will incur payment of Accountant General's interest on arrears.

(3) Subject to the aforesaid, neither party shall have any allegation and/or demand and/or claim against the other on this matter.

C. BENEFITS FOR COMPANY OFFICERS

(1) On April 6, 2005 the general meeting of the shareholders approved giving a commitment for indemnification in respect of a financial liability imposed on Company officers and in respect of reasonable litigation expenses they incur, in everything connected directly or indirectly with the proceeding for the sale of the State's holdings in the Company by way of a private placement of 30% of the share capital of the Company and options to purchase an additional 10.66% of the share capital of the Company. The commitment to indemnify will be made to officers who served and/or were appointed and/or will be appointed in the Company commencing from the start of the Company's preparations in connection with the sale proceeding until the closing of the sale proceeding.
The total scope of the indemnity will not exceed 25% of the shareholders' equity of the Company (according to the 2004 financial statements, linked to the CPI of November 2004), including in respect of undertakings for advance indemnification made up to the date of issue of the letter of indemnification together with an undertaking for indemnification in advance in accordance with the letter of the Minister of Finance dated April 21, 2004, which will be given, if given, immediately prior to transfer of the controlling interest in the Company by the State.

(2) On April 20, 2005 the Audit Committee and the Board of Directors of the Company resolved to insure and indemnify the Company's officers as follows:

(a) Approval for exercise of an option to purchase a run-off policy for the liability of the Company's officers, on the terms of the present policy, in accordance with the following changes:

(1) For a period of seven years from the date of the closing of the transfer of the State's shares in the Company which are being sold in accordance with the decision of the Ministerial Committee on Privatization of July 19, 2004 ("the Closing Date of the Sale").

NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

C. BENEFITS FOR COMPANY OFFICERS (CONTD.)

(2) (a) (Contd.)

(2) The total amount of the insurance cover will not exceed $150 million plus $30 million in respect of legal expenses in Israel only.

(3) Limits of liability:
a. for the first three years, cover has a limit of liability of $150 million plus $30 million in respect of legal expenses in Israel only;
b. for another three years cover has a limit of liability of $75 million plus $15 million in respect of legal expenses in Israel only;
c. for the seventh year, cover has a limit of liability of $25 million plus $5 million in respect of legal expenses in Israel only.

It should be made clear that there is one limit of liability for the entire run-ff period.

(4) The amount of the premium for the entire period of insurance is $3 million (in a one-time advance payment).

(b) Approval for making a commitment in advance to indemnify the officers of the Company who were serving in the Company at the time of making the commitment to indemnify, which will apply on the date of completion of the sale, or who served during the seven years prior to that date, in respect of a financial liability imposed upon them in each of the events detailed in the indemnity document and on the terms set out therein, in which the officer acted in good faith and had reasonable grounds for assuming that the action is for the good of the Company. The undertaking to indemnify will not apply with regard to an event for which an insurer acknowledges liability under an insurance policy, but if the officer was ordered, in respect of an event which could be indemnified, to pay an amount exceeding the amount he was paid by the insurer, the Company will indemnify him with the difference, and subject to the amount of the indemnity for all the officers in the Company not exceeding $150 million, plus $30 million in respect of legal expenses in Israel only, per claim, and in total for each year of insurance during the period of the insurance.

The above decisions require the approval of the general meeting of the shareholders, which is scheduled to convene on May 16, 2005.

Notes to the Interim Consolidated Financial Statements as at March 31, 2005

NOTE 8 – REVENUES FROM TELECOMMUNICATION SERVICES

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenues from communication services–			
Domestic fixed-line communications - traffic	**368,237**	422,463	1,567,631
Fixed fees	**624,370**	613,133	2,501,250
Cellular telephone	**927,364**	517,352	2,699,876
International communications and internet services	**188,566**	190,342	771,290
Multi-channel television	**284,134**	–	529,838
Installation and sale of equipment to subscribers	**282,035**	167,106	825,390
Other	**32,172**	16,521	89,448
	2,706,878	1,926,917	8,984,723
Other revenues	**66,245**	82,304	285,081
	2,773,123	2,009,221	9,269,804

Notes to the Interim Consolidated Financial Statements as at March 31, 2005

NOTE 9 – OPERATING AND GENERAL EXPENSES

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses –			
Operational	**437,596**	407,041	1,578,426
General and administrative	**162,443**	75,109	549,869
Total salaries and incidentals	**600,039**	482,150	2,128,295
General expenses	**299,514**	178,135	996,323
Materials and spare parts	**256,546**	138,567	643,013
Consumption of content from satellite services	**100,198**	–	200,469
Cellular telephone expenses	**254,521**	126,895	700,890
Building maintenance	**86,807**	68,777	352,430
Services and maintenance by sub-contractors	**105,761**	69,535	341,999
International communications expenses	**64,027**	45,770	228,936
Motor vehicle maintenance expenses	**40,086**	29,725	144,630
Collection fees	**12,073**	8,758	39,357
	1,819,572	1,148,312	5,776,342
Less – salaries charged to investment in fixed assets	**55,721**	57,500	211,252
	1,763,851	1,090,812	5,565,090

NOTE 10– OTHER INCOME (EXPENSES), NET

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Provision for claims for salary and pension components	**–**	–	207,000
Provision for employee severance benefits upon early retirement	**(7,000)**	(30,000)	(105,000)
Provision for impairment and other liabilities in respect of investments in other companies	**–**	–	(26,000)
Compensation in respect of settlement agreement	**14,483**	–	–
Amortization of goodwill	**(23,279)**	–	(35,135)
Capital gain from sale of operation (1)	**101,860**	–	35,033
Capital gains, net	**1,730**	(80)	7,338
Other	**(180)**	(372)	(3,556)
	87,614	(30,452)	79,680

(1) Further to Note 9C to the financial statements for the year ended December 31, 2004, concerning the sale of the Company's holdings in the satellite corporation IntelSat, the sale transaction was closed on January 28, 2005 at its original price. The capital gain in the full amount of the consideration was charged to the Statement of Operations in the present quarter.

Notes to the Interim Consolidated Financial Statements as at March 31, 2005

NOTE 11 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. Statements of Operations

	For the three-month period ended March 31		For the year ended December 31
	2005	2004	2004
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenues (Note 11B)	**1,195,718**	1,267,978	4,959,691
Costs and expenses			
Operating and general expenses (Note 11C)	**562,004**	554,203	2,347,448
Depreciation	**349,395**	380,695	1,495,909
Royalties to the Government of Israel	**35,386**	36,771	145,318
	946,785	971,669	3,988,675
Operating income	**248,933**	296,309	971,016
Financing expenses, net	**(5,927)**	(13,866)	(93,216)
Earnings after financing expenses, net	**243,006**	282,443	877,800
Other revenues (expenses), net	**110,771**	(29,932)	109,904
Earnings before income tax	**353,777**	252,511	987,704
Income tax	**(103,046)**	(86,091)	(387,079)
Earnings after income tax	**250,731**	166,420	600,625
Company's equity in earnings of investee companies	**13,976**	1,502	20,200
Earnings before the cumulative effect of change in accounting method	**264,707**	167,922	620,825
Cumulative effect of change in accounting method*	**15,000**	–	–
Net earnings	**279,707**	167,922	620,825

* See Note 2B

NOTE 11 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. REVENUES FROM TELECOMMUNICATIONS SERVICES

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Fixed-line domestic communications			
Traffic	**380,460**	425,977	1,590,671
Fixed fees	**585,894**	585,354	2,354,700
Total revenues from fixed-line communications	**966,354**	1,011,331	3,945,371
Cellular telephone	**92,660**	107,067	414,740
International communications	**28,519**	34,884	126,856
Installation and sale of equipment to subscribers	**19,940**	45,433	169,508
Other	**34,235**	18,879	97,472
	1,141,708	1,217,594	4,753,947
Other revenues	**54,010**	50,384	205,744
	1,195,718	1,267,978	4,959,691

C. GENERAL AND OPERATING EXPENSES

	For the three-month period ended March 31		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses –			
Operational	**277,467**	290,723	1,122,381
General and administrative	**68,640**	57,973	271,310
Total salaries and incidentals	**346,107**	348,696	1,393,691
General expenses	**73,760**	78,317	341,977
Materials and spare parts	**20,890**	29,728	114,443
Building maintenance	**78,226**	62,037	315,074
Services and maintenance by sub-contractors	**50,141**	53,524	205,192
International communications expenses	**5,075**	4,310	27,105
Motor vehicle maintenance expenses	**28,430**	25,317	111,359
Collection fees	**8,797**	8,547	36,904
	611,426	610,476	2,545,745
Less– salaries charged to investment in fixed assets	**49,422**	56,273	198,297
	562,004	554,203	2,347,448

Notes to the Interim Consolidated Financial Statements as at March 31, 2005

NOTE 12 – 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 three-month period ended March 31, 2005						
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	**1,132,440**	**1,106,280**	**193,812**	**284,394**	**56,197**	**–**	**2,773,123**
Inter-segment revenues	**63,151**	**4,040**	**5,359**	**4,268**	**27,246**	**(104,064)**	**–**
Total revenues	**1,195,591**	**1,110,320**	**199,171**	**288,662**	**83,443**	**(104,064)**	**2,773,123**
Segment results*	**248,933**	**121,269**	**20,517**	**(24,453)**	**(53)**	**–**	**366,213**

	For the three-month period ended March 31, 2004						
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	1,216,871	533,661	193,563	–	65,126	–	2,009,221
Inter-segment revenues	51,107	1,472	4,047	–	9,528	(66,154)	–
Total revenues	1,267,978	535,133	197,610	–	74,654	(66,154)	2,009,221
Segment results*	296,309	66,810	34,549	–	1,577	–	399,245

	For the year ended December 31, 2004						
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	4,736,756	2,966,486	797,735	529,838	238,989	–	9,269,804
Inter-segment revenues	222,935	8,493	18,704	12,304	80,387	(342,823)	–
Total revenues	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Segment results*	971,016	379,328	118,223	(85,381)	8,362	–	1,391,548

* Segment results do not include Other revenues (expenses), net, as stated in Note 10.

Notes to the Interim Consolidated Financial Statements as at March 31, 2005

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD.

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheet

	March 31, 2005 (Unaudited)	March 31, 2004 (Unaudited)	December 31, 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**1,472,269**	1,311,664	1,413,049
Long-term trade receivables	**299,820**	206,708	278,778
Investment in investee companies	**3,521**	1,767	4,084
Deferred income taxes	**73,901**	192,824	106,503
Fixed assets, net	**3,055,918**	2,937,676	3,093,675
Other assets, net	**335,939**	386,226	334,028
	5,241,368	5,036,865	5,230,117
Current liabilities	**1,320,297**	1,995,764	1,794,413
Provision for losses of investee company	**–**	5,264	–
Long-term liabilities	**1,719,959**	1,102,560	1,305,674
Shareholders' equity	**2,201,112**	1,933,277	2,130,030
	5,241,368	5,036,865	5,230,117

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. Statement of Operations

	For the three-month period ended March 31		For the year ended December 31
	2005	2004	2004
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenues from Pelephone services, sales and services	**1,110,321**	1,070,264	4,412,344
Cost of Pelephone services, sales and services	**859,151**	780,031	3,238,533
Gross profit	**251,170**	290,233	1,173,811
Sales and marketing expenses	**104,980**	115,993	469,353
General and administrative expenses	**24,917**	41,322	145,334
	129,897	157,315	614,687
Operating income	**121,273**	132,918	559,124
Financing expenses, net	**(10,127)**	(23,710)	(99,597)
Other income (expenses), net	**42**	(2,745)	3,645
Earnings before income tax	**111,188**	106,463	463,172
Income tax	**(36,602)**	(37,800)	(153,400)
Earnings after income tax	**74,586**	68,663	309,772
Company's equity in losses of investee companies	**(3,504)**	(2,406)	(9,080)
Net earnings	**71,082**	66,257	300,692

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD.

A. Balance sheet

	March 31, 2005 (Unaudited)	March 31, 2004 (Unaudited)	December 31, 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**131,581**	106,090	124,393
Broadcasting rights, net	**150,621**	128,724	140,496
Fixed assets, net	**1,088,292**	1,084,726	1,102,066
	1,370,494	1,319,540	1,366,955
Current liabilities	**608,559**	1,907,296	595,229
Long-term liabilities	**1,291,075**	22,002	1,299,138
Loans from shareholders	**2,714,884**	2,306,469	2,661,540
Capital deficit	**(3,244,024)**	(2,916,227)	(3,188,952)
	1,370,494	1,319,540	1,366,955

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD. (CONTD.)

B. Statement of Operations

	For the three-month period ended March 31		For the year ended December 31
	2005	2004	2004
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenues from DBS services	**288,662**	235,788	1,027,992
DBS operating expenses	**256,415**	262,247	1,013,403
Operating profit (loss)	**32,247**	(26,459)	14,589
Sales and marketing expenses	**33,423**	27,889	133,511
General and administrative expenses	**20,144**	18,792	72,240
	53,567	46,681	205,751
Loss from ordinary operations	**(21,320)**	(73,140)	(191,162)
Financing expenses, net	**(39,419)**	(35,836)	(171,522)
Other expenses, net	**(80)**	(1,387)	(3,200)
Net loss	**(60,819)**	(110,363)	(365,884)

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. Balance sheet

	March 31, 2005 (Unaudited)	March 31, 2004 (Unaudited)	December 31, 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**254,370**	145,283	226,434
Long-term investments and debit balances	**21,926**	20,951	23,552
Fixed assets	**345,015**	384,124	355,439
Other assets	**17,314**	11,673	18,106
	638,625	562,031	623,531
Current liabilities	**227,377**	265,109	239,133
Long-term liabilities	**182,077**	180,179	181,982
Shareholders' equity	**229,171**	116,743	202,416
	638,625	562,031	623,531

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. Statement of Operations

	For the three-month period ended March 31		For the year ended December 31
	2005	**2004**	**2004**
	(Unaudited)	**(Unaudited)**	**(Audited)**
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues from international telecommunication services	**199,171**	197,610	816,439
Operating expenses	**132,335**	117,714	503,379
Gross profit	**66,836**	79,896	313,060
Marketing, general and administrative expenses	**46,319**	45,347	194,837
Operating income	**20,517**	34,549	118,223
Financing expenses, net	**(1,589)**	(3,106)	(4,301)
Earnings after financing expenses, net	**18,928**	31,443	113,922
Other income, net	**340**	1,167	4,656
Earnings before income tax	**19,268**	32,610	118,578
Tax benefit (income tax)	**6,778**	(323)	822
Earnings after income tax	**26,046**	32,287	119,400
Company's equity in earnings of an affiliate	**204**	531	1,440
Net earnings	**26,250**	32,818	120,840