March 7, 2011

Bezeq The Israel Telecommunication Corporation Ltd.

Periodic Report for the Year 2010

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LIST OF TERMS

A. Names of laws appearing in the report

Consumer Protection Law	Consumer Protection Law, 1981
Antitrust Law	Antitrust Law, 1988
Arrangements Law	Economic Policy for 2011-2012 (Legislative Amendments) Law, 2011
Companies Law	Companies Law, 19990
Non-Ionizing Radiation Law	Non-Ionizing Radiation law, 2006
Second Authority Law	Second Authority for Television and Radio Law, 1990
Planning and Construction Law	Planning and Construction Law, 1965
Communications Law	Communications (Telecommunications and Broadcasts) Law, 1982
Securities Law	Securities Law, 1968
Class Actions Law	Class Actions Law, 2006
Telegraph Ordinance	Wireless Telegraph Ordinance [New Version[, 1972
Communications Order	Communications (Telecommunications and Broadcasts) (Determination of an Essential Service Provided by Bezeq Israel Communications Corp.) Order, 1997
Frequency Regulations for Access Installations	Communications (Telecommunications and Broadcasts) (Frequencies for Wireless Access Installations) Regulations, 2002
Royalties Regulations	Communications (Telecommunications and Broadcasts) (Royalties) Regulations, 2001 and Communications (Telecommunications and Broadcasts) (Royalties) (Temporary Order) Regulations, 2011
Royalties Regulations (Satellite Broadcasts)	Communications (Telecommunications and Broadcasts) (Satellite Television Broadcasts) (License fees and Royalties), 1999
Interconnect Regulations	Communications (Telecommunications and Broadcasts) (Payments for Interconnect) Regulations, 5760
Satellite Broadcasting License Regulations	Communications (Telecommunications and Broadcasts) (Proceedings and Conditions for Grant of a Satellite Broadcasts License), 1998
International Operator License Regulations	Communications (Telecommunications and broadcasts) (Proceedings and terms for receipt of a general license for providing international telecommunications services) Regulations, 2004

B. Other principal technological terms appearing in the report[1]

Bezeq On Line	Bezeq On Line Ltd.
Bezeq International	Bezeq International Ltd.
Bezeq Zahav Holdings	Bezeq Zahav (Holdings) Ltd.
B Communications	B Communications Ltd. (formerly – 012 Smile Communications Ltd.)
2010 Financials	The consolidated financial statements of the Company for the year ended December 31, 2010
DBS 2010 Financials	The financial statements of DBS for the year ended December 31, 2010, which are attached to this report
interconnect fees	Interconnect fees (also called "call completion fees") are paid by one carrier to another for interconnection (see definition below)

[1] Please note that the definitions are for reader convenience only, and are not necessarily identical to the definitions in the Communications Law or its Regulations.

DBS	D.B.S. Satellite Services (1998) Ltd.
HOT	HOT Communications Systems Ltd. and corporations in its control which operate in broadcasting (multi-channel television)
HOT Telecom	HOT Telecom Limited Partnership
HOT-Net	HOT-Net Internet Services Ltd.
the Stock Exchange	The Tel Aviv Stock Exchange Ltd.
the Gronau Report	9, 2008The report published on March 8 by the committee appointed to formulate detailed recommendations concerning policy and the principles of competition in communications in Israel, headed by Prof. Gronau
Walla	Walla! Communications Ltd. and corporations in its control
Hayek Commission	Committee headed by Mr. Amir Hayek for reviewing the structure and updating of Bezeq tariffs and for setting wholesale service tariffs in fixed-line communications
Eurocom DBS	Eurocom D.B.S. Ltd.
Mirs	Mirs Communications Ltd. and corporations in its control
public switching	A telephony system supporting the connection of installations for passing calls between various end units
Mbps	Megabits per second; a unit of measure for the speed of data transfer
Domestic Carrier	An entity providing fixed-line domestic telephony services under a general or special domestic carrier license
PVR decoders	Digital decoders enabling viewing of satellite broadcasts, with recording ability on a hard disk (Personal Video Recorder) and enabling other advanced services
HDPVR decoders	PVR decoders that also enable receipt of HD broadcasts in addition to the other services provided by PVR decoders
Roaming	Roaming services allow a customer of one communications network to receive services from another communications network which is not his home network, based on roaming agreements between the home network and the host network
NEP	Network End Point – an interface to which a public telecommunications network and terminal equipment or a private network are connected. NEP services include the supply and maintenance of equipment and services on the customer's premises
Cellcom	Cellcom Israel Ltd. and corporations in its control
Pelephone	Pelephone Communications Ltd. and corporations in its control
Partner	Partner Communications Ltd. and corporations in its control
interconnect	Interconnect enables telecommunications messages to be transferred between subscribers of various license-holders or services to be provided by one license-holder to the subscribers of another license-holder; interconnect is made possible by means of a connection between a public telecommunications network of one license-holder (e.g. the Company) and a public network of another license-holder (e.g. a cellular operator). See also the definition of "interconnect fees".
cellular	Mobile radio-telephone; cellular telephony
ITS license	General license for providing international telecommunications services
domestic carrier license	General license for providing fixed-line domestic telecommunications services
cellular license	General license for providing mobile radio-telephone services by the cellular method
broadcasting license	License for satellite television broadcasts

transmission services	Transfer service for electromagnetic signals or a series of bits between telecommunications facilities of a license-holder (excluding terminal equipment)
data communication services	Network services for transferring data from point to point, transferring data between computers and between different communications networks, communications network connection services for the Internet, and remote access services for businesses
012 Smile	012 Smile Telecom Ltd. and corporations in its control
ARPU	Average Revenue Per User
CDMA	Code Division Multiple Access – Access technology for cellular communications networks based on separation of subscribers by encoding
xDSL	Digital Subscriber Line – Technology that uses copper wires of telephone lines to transfer data (the Internet) at high speeds by using frequencies higher than the audible frequency and therefore enabling simultaneous call and data transfer
DTT	Digital Terrestrial Television – Wireless digital broadcast of television channels by means of terrestrial transmission stations
GSM	Global System for Mobile Communications – International standard for cellular communications networks ("2nd Generation")
HD	High Definition TV
HSPA	Cellular technology succeeding the UMTS standard, enabling data transfer at high speeds ("3.5 Generation")
IP	Internet Protocol. The protocol enables unity between voice, data and video services using the same network
IPVPN	Virtual Private Network based on IP and located on the public network, through which it is possible to (a) enable end users to connect to the organizational network by remote access, and (b) connect between the organization's branches (intranet)
ISP	Internet Service Provider – Holder of a special license for providing Internet access services. The Internet access provider is the entity enabling the end user to connect to TCP/IP protocol that links him and the global Internet
MOU	Minutes of Use – the average number of minutes of use of a subscriber to the communications services
MVNO	Mobile Virtual Network Operator – A virtual cellular operator that uses the existing communications infrastructures of the cellular carriers without need for its own infrastructures
NGN	Next Generation Network – The communications network of the next generation, based on IP architecture
PSTN	Public Switch Telephone Network – The Company's long-standing fixed-line domestic communications infrastructure
UMTS	International standard for cellular communications developed from the GSM standard ("3rd Generation")
VDSL2	Very High Bit Rate Digital Subscriber Line – Digital Subscriber Line (DSL) with very high speed. One of the fastest technologies for data transfer at high bandwidth on ordinary telephone lines
VoB	Voice over Broadband – Telephony and associated services in IP technology using fixed-line broadband access services
VoC	Voice over Cellular Broadband – Telephony services over a cellular data communications channel ("Mobile VoB Services")
VOD	Video on Demand – Television services per customer demand

VoIP	Voice over Internet Protocol – Technology enabling the transfer of voice messages (provision of telephony services) by means of IP protocol
Wi Fi	Wireless Fidelity – Wireless access to the Internet within a local space

CHAPTER A – DESCRIPTION OF THE COMPANY'S BUSINESS

"Bezeq" – The Israel Communications Corp Ltd. (**"the Company"** or **"Bezeq"**), together with its subsidiaries, whether wholly or partly owned, whose financial statements are consolidated with those of the Company, as well as D.B.S. Satellite Services (1998) Ltd., an affiliate, are hereafter together referred to in this Periodic Report as **"the Group"** or **"Bezeq Group"**.[2]

1. General development of the Group's business

1.1 Group activities and business development

1.1.1 General

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

The Company was established in 1980 as a government company to which the activities carried out until then at the Ministry of Communications were transferred, and it was privatized over a period of years. The Company became a public company in 1990 and its shares are traded on the Tel Aviv Stock Exchange.

Since April 14, 2010, the controlling shareholder of the Company is B Communications, through its wholly-controlled (indirectly) company B Communications (SP2) Ltd. ("B Tikshoret"), which at March 1, 2011 holds 30.39% (29.08% at full dilution).[3] For details about the agreement for acquisition of control in the Company, see Section 1.3.1.

Below is a schematic of the structure of holdings in the Company and the Company's holdings in the subsidiaries and principal affiliates, at March 1, 2011.

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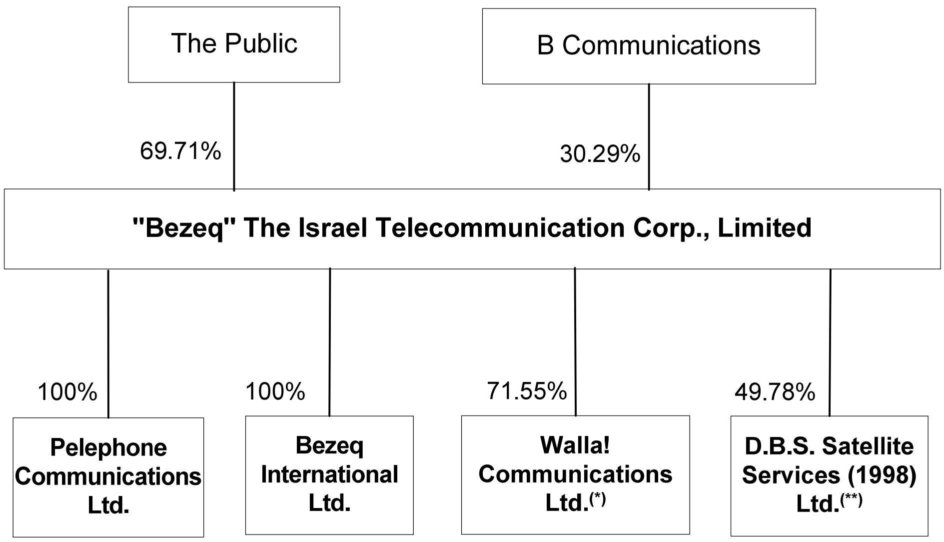
2 We draw attention to the fact that the financial statements of DBS are not consolidated with those of the Company, and therefore, the definition of "the Group" in the 2010 Financials differs from its definition in the Chapter "Description of the Company's Business" in the reports of previous years in that it no longer includes DBS.

3 B Communications is a private company registered in Israel, wholly owned and controlled by B Tikshoret (SP1) Ltd., which is wholly owned and controlled by B Communications. B Communications is an Israeli public company whose shares are traded by way of double listing on the Stock Exchange and on Nasdaq. The controlling shareholder in B Communications is Internet Gold – Golden Lines Ltd., and the controlling shareholder in Internet Gold – Golden Lines Ltd. is Eurocom Communications Ltd. (**Eurocom Communications"**), which is controlled by Eurocom Holdings (1979) Ltd., in which the controlling shareholder is Mr. Shaul Elovitz. The shares of B Tikshoret in the Company are held through a trustee for B Tikshoret as owner and for entities who made financing available to B Tikshoret as lien-holders.



(*) A public company traded on the Stock Exchange.

(**) The Company has options which, at the date of publication of the Periodic Report, grant a right to 8,6% of the shares of DBS (on the non-approval of a merger between the Company and DBS, see Section 1.1.2). The remainder of DBS's shares are held by Eurocom DBS, as described in Section 1.1.2.

In addition, the Company holds 100% of the issued capital of Bezeq On Line, which operates customer call centers of a scope that is not material to the Company, and 100% of the issued capital of Bezeq Zahav Holdings, whose entire operation is the holding of Debentures Series 5 of the Company (see Section 2.17.1).

Below are details of the present holdings in the Company at full dilution, assuming exercise of all the options actually allotted to Group employees and managers (see Section 1.3.2), on December 31, 2010 and at March 1, 2011.

Shareholders	Percentage of holdings		
	At December 31, 2009	At March 1, 2011	At full dilution at March 1, 2011[4]
B Communications (through B Tikshoret)	30.31%	30.29%	29.08%
The Public	69.69%	69.71%	70.92%

1.1.2 Mergers and acquisitions

DBS

In view of the decision of the Supreme Court in 2009 not to approve the merger of the Company and DBS (see Section 2.16.8C), the Company ended its control in DBS and commencing August 21, 2009 it ceased consolidation of the financial statements in its financial statements and since that date its investment in DBS shares is stated by the equity method. On this matter, see Note 5 to the 2010 Financials.

To the best of the Company's knowledge, on November 28, 2010, transactions of Eurocom DBS,[5] a DBS shareholder, were closed for the purchase of all the holdings and the rights of other shareholder (excluding the Company) in DBS.[6] All the acquired shares

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4 The calculation of full dilution assumes that the allotted options will be exercised for shares. In view of the mechanism of exercise of stock appreciation rights in the plan for managers and senior employees in the Group (see Sections 1.3.2 and 2.9.7), this assumption is theoretical only, since in practice, under the terms of the plan and according to the outline, offerees who exercise the options will not be allocated the full number of shares underlying them, only the number of shares that reflects the amount of the financial benefit embodied in the options.

5 Eurocom DBS is indirectly controlled by Mr. Shaul Elovitz, the controlling shareholder (indirectly) in the Company.

6 The other shareholders in DBS were Gilat DBS Ltd.. Lidan Investment Agencies (1994) Ltd., Polar Communications Ltd., Mr. Yoav Harlap and Naniach Ltd.

(approximately 17.6% of the issued and paid up capital of DBS) were placed by Eurocom DBS with a trustee, which holds in trust for it the remainder of its holdings in DBS,[7] so that thereafter, the trustee holds for Eurocom DBS approximately 50.22% of the issued and paid up capital of DBS. The approval of the Antitrust Commissioner for B Communications' transaction to acquire control in the Company was made contingent, among other things, on the sale of Eurocom DBS's holdings in DBS within a defined period of time. See Section 1.3.1.

Walla

Following an announcement in Haaretz Publishing Ltd. (**"Haaretz"**) on March 14, 2010, of its agreement to sell its shares in Walla, on April 25, 2010 Bezeq International exercised its right of first refusal for the Walla shares owned by Haaretz and purchased 14.807,939 shares (**"the Acquired Shares"**) for NIS 6 per share, and in all – NIS 88,847,634. Upon receipt of the Acquired Shares, Bezeq International transferred some of them to a trustee to be held in a blind trust, so that after the transfer, Bezeq International held shares accounting for 44.99% of the issued and paid up capital of Walla.

On September 2, 2010, Bezeq International completed the purchase of an additional 2,274,299 shares of Walla (accounting for approximately 5% of the issued and paid up capital of Walla) by means of a special tender offer in accordance with the Companies Law and the Securities (Tender Offer) Regulations, 2000, at NIS 6 per share and a total consideration of NIS 13,645,794.

Subsequently, and after receipt of the approval of the Antitrust Commissioner,[8] on September 21, 2010 all the Walla shares held by the trustee were returned to Bezeq International, and on the same date, the Company purchased all the shares in Walla held by Bezeq International (32,644,997 shares) at NIS 6 per share (for a total of NIS 195.87 million), so that after the purchase, the Company holds approximately 71.76% of the shares of Walla.

Yad 2

Acquisition of Yad 2 – On September 2, 2010, Walla signed an agreement for the acquisition of 75% of the share capital of Koral Tel Ltd. ("Yad 2"), a private company that operates the Yad 2 site on the Internet, in consideration of NIS 117.5 million plus an additional sum to be paid to some of the sellers based on the working capital of Yad 2 and subject to adjustments, and which is not expected to be material for the Company. On this matter, see also Note 5B to the 2010 Financials.

1.2 Segments of operation

The Group has four principal segments of operation which correspond to the corporate division among the Group companies and report as business segments in the Company's consolidated financial statements (see also Note 29 to the 2010 Financials):

1.2.1 The Company – Fixed-line domestic communications

This segment consists primarily of the Company's operation as a Domestic Carrier, including telephony services, Internet infrastructure and access services, transmission and data communications services. The Company's activities in the domestic fixed-line segment are described in Section 2 of this report.

1.2.2 Pelephone – Cellular communications

Cellular communications, marketing of terminal equipment, installation, operation and maintenance of cellular communication equipment and systems. Pelephone's operations are described in Section 3.

It is noted that prior to the acquisition, Eurocom DBS approached the Company, as required by the Articles of Association of DBS and the DBS shareholders agreement, with an offer to exercise its right of first refusal. Subsequently, the Company gave notice that it had decided not to exercise the right in view of the March 2009 decision of the Supreme Court prohibiting the Company from increasing its holdings in DBS to more than 50%.

7 The shares are registered to Eurocom DBS and irrevocable power of attorney was granted to the trustee – see Section 1.3.1.a.2.

8 See Section 2.16.8E.

1.2.3 Bezeq International – International communications, Internet and NEP services

Internet access services (ISP), international communications services and NEP services. Bezeq International's operations are described in Section 4.

1.2.4 DBS – Multi-channel television

Multi-channel digital satellite television broadcasting services for subscribers (DBS) and the provision of value added services for subscribers. DBS's operations are described in Section 5.

It is noted that in addition, the Company's consolidated financial statements include an "Others" segment, which covers mainly Internet-related fields and the operation of Internet portals (through Walla), customer call center services (through the subsidiary Bezeq Online) and investment in a venture capital fund. The Others segment is not material at the Group level.

1.3 Investments in the Company's capital and transactions in its shares

1.3.1 Transactions in Bezeq shares

A. Sale of core control

On April 14, 2010, a transaction was closed between the previous controlling shareholder in the Company, Ap.Sb.Ar. Holding Ltd. ("Ap.Sb.Ar") and B Communications, for the off-the-floor sale of all of Ap.Sb.Ar's shares in the Company – 814,211,545 ordinary shares of NIS 1 par value each, accounting at that time for approximately 30.44% of the issued and paid up capital of the Company, at NIS 8 per share and a total consideration of NIS 6,513,692,260.

The Company was told that the transaction was closed after all the preconditions to the agreement were met, including receipt of all the regulatory approvals required by law, including these:

1. Ministry of Communications approvals (including grant of control permits). The approvals were made contingent upon certain conditions, mainly – a determination that transactions between Eurocom Group[9] and Pelephone for the purchase of terminal equipment would be considered an exceptional transaction under Section 270(4) of the Companies Law, and in addition to the approval proceeding employed at Pelephone, also an approval proceeding in the Company; board discussions on the matter must be documented in complete and detailed minutes and forwarded to the Director General at the Ministry of Communications (these two conditions were applied also to DBS with regard to transactions concerning satellite terminal equipment); Eurocom Group would not transfer to Pelephone any information relating to the supply / provision of products and services to its (Pelephone's) competitors; an employee of Eurocom Cellular Communications Ltd. would not serve as a director in Pelephone and vice versa. Other directives related to DBS shares held in trust (see sub-section 2 below).
2. Approval of the Antitrust Commissioner. The approval was made contingent upon certain conditions, mainly – the imposition of a ban on Eurocom Group[10] being involved in the determination of commercial terms that a cellular company purchasing terminal equipment from Eurocom Cellular Communications Ltd. offers consumers in Israel, other than participation in financing the sales campaigns of the cellular company, and a requirement for Eurocom Group to sell its holdings in DBS. Until those holdings were sold, Eurocom Group was required

[9] For this matter, Eurocom Group means all the corporations controlled, directly or indirectly, by Eurocom Holdings (1979) Ltd. and/or Eurocom Media-Net Holdings Ltd., excluding the Company, Pelephone, Bezeq International and B.E.P Communications Solutions Limited Partnership, as well as employees of Bezeq and those companies who are not employees in other companies in the Group.

[10] For this matter, Eurocom Group means all the corporations controlled, directly or indirectly, by Eurocom Holdings (1979) Ltd. and/or Eurocom Media-Net Holdings Ltd., as well as any person related to those companies and excluding the Company and companies in which the Company holds more than 50% of the shares.

to transfer its shares in DBS to a trustee, who would act as owner of the shares and exercise its authority and/or rights at its discretion for the benefit of DBS only, under irrevocable power of attorney. Eurocom Group would no issue instructions or guidelines to the trustee (other than in connection with sale of the shares subject to the provisions in the Commissioner's decision), nor would the trustee be subject to the interests of Eurocom Group or its objectives, directly or indirectly.

In the matter of Eurocom DBS's shares in DBS in respect of which the trustee received the aforementioned power of attorney, it was determined, with the approval of the Ministry of Communications, that any change in the trustee's holding in DBS requires the approval of the Ministry of Communications, and that the trustee would act on an instruction received from any entity that concerned, directly or indirectly, the arrangement of the Ministry of Communications only after receipt of the Ministry's approval.

3. Approval of the Prime Minister and the Minister of Communications in accordance with the provisions of the Communications Law and of the Communications Order, including the approval of corporations from B Communications Group and the controlling individuals in it to control Bezeq (**"the Control Permits"**). The Control Permit is contingent, inter alia, upon the percentage of B Tikshoret's holding in the Company not falling below 30% (**"the Minimum Percentage"**), subject to a number of exceptions stated in the Communications Order.[11]

The Company's shares were purchased through B Tikshoret.

After the transfer of control in the Company the competent organs of the Company approved various engagements of the Company and its subsidiaries[12] with B Communications Group, including exceptional transactions. Such approval of transactions was given from time to time in accordance with the needs of the Company and its subsidiaries and was duly reported to the public. For additional information, see Section 9 in Chapter D of the Periodic Report and Note 30 to the 2010 Financials.

B. Other transactions in Bezeq shares

1. On August 10,2009, October 19, 2009 and November 9, 2009, transactions were closed for the sale of Company shares held at the time by Zeevi Communications Holdings Ltd. (in receivership) ("Zeevi") through UBS Limited investment house, so that after the last transaction as closed, all the Company shares still held by Zeevi were sold, whereupon Zeevi ceased to have an interest in the Company. The transactions:

Date	Number of shares sold (NIS 1 par value each)	Total price (NIS)	Price per share (NIS)
Aug. 10, 2009	155,000,000	1,151,650,000	7.43
Oct. 19, 2009	120,000,000	976,800,000	8.14
Nov. 9, 2009	184,331,617	1,533,270,390	8.318

2. On August 11,2009 a transaction was closed for the distribution of 149,376,642 Bezeq shares of NIS 1 par value each which were held by Ap.Sb.Ar. through Citigroup Global Markets Ltd., in consideration of NIS 1,120,324,815, so that after the distribution, no buyer held more than 5% of the Company's share capital.

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11 It is noted that on February 2, 2011, the Prime Minister and Minister of Communications gave approval permitting the Minimum Percentage to fall to 29%, provided that the cause was an allotment of Company shares as part of an exercise of employee stock options, and for a period of six months from the date of decrease of the Minimum Percentage. The approval will take effect on the date of the decrease to below the Minimum Percentage. At the end of the six months, the approval will expire and the Minimum Percentage will apply.

12 Concerning the approval of engagements of the subsidiaries Pelephone, Bezeq International and Bezeq On Line, and of DBS – the Company's approval was given after approval of the transactions by the competent organs of those companies.

3. On September 17, 2009 a transaction was closed for the distribution of 95,623,358 Bezeq shares of NIS 1 par value each, which were held by Ap.Sb.Ar. through Citigroup Global Markets Ltd., in consideration of NIS 748,730,893, so that after the distribution no buyer held more than 5% of the Company's share capital. On completion of sale of the shares described in this sub-section, the holdings of Apo.Sb.Ar. in the Company fell to approximately 30.68% (26.99% at fill dilution).
4. On December 10, 2009, Amitim (the veteran pension funds in the arrangement – under special management) ("Amitim") notified the Company that it had become an interested party in the Company following an off-the-floor purchase of 63,928,590 ordinary shares of NIS 1 par value each of the Company for NIS 8.534 per share, so that after the purchase, Amitim held 195,605,625 Company shares which at the time accounted for approximately 7.36% of the issued capital of the Company. On December 19, 2009 Amitim ceased to be an interested party in the Company.

1.3.2 Employee stock option plans

For details of employee stock option plans, see Section 2.9.7.

Options exercised in 2009, 2010 and up to March 1, 2011:

	No. of shares issued due to exercise of options	Total exercise price paid to the Company
2009	54,682,019	128,362,819
2010	26,189,422	26,068,365
Jan.1 ,2011 – March 1, 2011	2,333,005	1,646,677

1.4 Distribution of dividends

1.4.1 Dividend policy

On August 4, 2009, the Board of Directors of the Company resolved to adopt a dividend distribution policy under which the Company would distribute to its shareholders, once every six months, a dividend of 100% of the half-yearly profit (after tax) ("Profit for the period attributable to the Company's owners") according to the consolidated financial statements of the Company. Implementation of the dividend distribution policy is subject to the provisions of any law, including the distribution tests laid down in the Companies Law, and to the Board's assessment as to the Company's ability to meet its existing and foreseen obligations, and all with due attention to the Company's projected cash flow, activities and liabilities, its cash balances, its plans and its situation from time to time, and subject to the approval of the general meeting of the shareholders of the Company for each specific distribution, as provided in the Company's Articles of Association. Since the date of that decision, the Company has not changed its dividend policy.

1.4.2 Dividend distribution

Distributions made by the Company during 2009-2010 and up to the date of publication of this Periodic Report:

Date of distribution	Type of distribution	Total sum distributed (NIS millions)	Sum distributed per share (NIS)
May 24, 2009	Cash dividend	792	0.3013025
October 5, 2009	Cash dividend	1,149	0.4329743
May 3, 2010	Cash dividend	2,453[13]	0.9170679
October 7, 2010	Cash dividend	1,280	0.4780459

13 Of this sum, NIS 1,538 million as a result of ending the consolidation of DBS (see Note 13 to the 2010 Financials). For the matter of distribution of this sum, an external legal opinion was presented to the Board of Directors.

The above dividends were distributed in accordance with the Company's dividend distribution policy noted in Section 1.4.1.[14]

The balance of distributable profits at the date of the report – NIS 1,163 million (surpluses accumulated in the past two years after deduction of prior distributions).

On March 7, 2011, the Board of Directors of the Company resolved to recommend to the general meeting of the shareholders of the Company the distribution of a cash dividend to the shareholders in the amount of NIS 1,163 million. At the date of the report, this dividend has not yet been approved by the general meeting.

1.4.3 Distribution that does not pass the profit test

On December 30, 2010, the Board of Directors resolved to approve, and to recommend that the general meetings of its shareholders approve, a distribution to the shareholders of the Company (**"the Planned Distribution"**) in a total amount of NIS 3 billion, a sum which exceeds the Company's profits as defined in Section 302 of the Companies Law,, where the amount of the Planned Distribution would be distributed to the shareholders, as far as possible, in six equal half-yearly portions during the years 2011-2013 (without payment of interest and linkage) together with the expected distribution of the regular dividend, and all in accordance with the principles and terms described in the immediate report of the Company on the subject of a distribution to the shareholders, dated December 30, 2010, which is cited by way of reference.

The general meeting of the shareholders approved the Planned Distribution on January 24, 2011.

The Planned Distribution is subject to the approval of the court. On January 26, 2011 the Company filed an application for approval of the Planned Distribution. On March 4, 2011 the court handed down its decision that the position of the Securities Authority on the matter must be filed within seven days.

For more details about the Planned Distribution, see (1) the immediate report on an application to the court for approval of a distribution which was published by the Company on January 26, 2011, to which the text of the application for approval of the distribution as filed in the court was attached, and (2) an immediate report about the distribution published by the Company on February 17, 2011,which includes explanations and additional emphases relating to the Planned Distribution, cited here by way of reference. And for the matter of the Company's rating, see Section 2.13.6.

The effects of a distribution that does not pass the profit test on the equity of the Company at December 31, 2010: total capital prior to the distribution – NIS 5,370 million; total capital after the distribution – NIS 2,370 million.

[14] The May 2009 dividend was distributed before adoption of the dividend distribution policy, but is nevertheless in keeping with it (i.e. distribution of 100% of the half-yearly profit (after tax) according to the consolidated financial statements of the Company).

1.5 Financial information about the Group's segments of operation

All the data in this Section 1.5 are in NIS millions.

1.5.1 2010:

	Domestic fixed line communications	Mobile radio telephone	International communications, Internet services and NEP	Multi-channel television	Others	Adjustments to consolidated**	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Total revenues:							
From externals	4,990	5,474	1,333	1,578	178	(1,578)	11,975
From other segments of operation in the corporation	273	258	47	5	32	(603)	12
Total income	5,263	5,732	1,380	1,583	210	(2,181)	11,987
Total costs attributable to:							
Variable costs attributable to segment of operation*	1,414	2,311	668	553	97		
Fixed costs attributable to segment of operation*	1,806	2,038	392	852	99		
Total costs	3,220	4,349	1,060	1,405	196	(1,987)	8,243
Costs that do not constitute revenue in another segment of operation	2,957	4,145	926	1,393	194	(1,377)	8,238
Costs that constitute revenue of another segment of operation	263	204	134	12	2	(610)	5
Total costs	3,220	4,349	1,060	1,405	196	(1,987)	8,243
Profit from ordinary operations attributable to owners of the Company	2,043	1,383	320	88	11	(104)	3,741
Profit from ordinary operations attributable to rights that do not grant control	-	-	-	90	3	(90)	3
Total assets attributable to operations at December 31, 2010	6,352	4,892	1,038	1,243	375	338	14,238
Total liabilities attributable to segment of operation at December 31, 2010	7,964	1,930	304	4,665	241	(6,236)	8,868

* The Group companies that are companies providing services (as opposed to manufacturing companies), do not manage a dedicated price system, which differentiates between fixed and variable costs. The above distinction was made for purposes of this report only. Variable costs are costs for which the companies have flexible management and control in the short-term and which directly affect output, compared with fixed expenses, which are not flexible in the short term and do not directly affect output.

** Details of adjustments to consolidated – Transactions between segments of operation and transactions in multi-channel television.

1.5.2 **2009:**

	Domestic fixed line communications	Mobile radio telephone	International communications, Internet services and NEP	Multi-channel television	Others	Adjustments to consolidated**	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Total revenues:							
From externals	5,039	5,130	1,273	1,529	54	(1,529)	11,496
From other segments of operation in the corporation	264	246	45	1	20	(553)	23
Total income	5,303	5,376	1,318	1,530	74	(2,082)	11,519
Total costs attributable to:							
Variable costs attributable to segment of operation*	1,774	2,153	635	498	47		
Fixed costs attributable to segment of operation*	2,006	2,033	422	784	23		
Total costs	3,780	4,186	1,057	1,282	70	(1,828)	8,547
Costs that do not constitute revenues in another segment of operation	3,543	4,003	934	1,259	66	(1,259)	8,546
Costs that constitute revenues in other segments of operation	237	183	123	23	4	(569)	1
Total costs	3,780	4,186	1,057	1,282	70	(1,828)	8,547
Profit from ordinary operations attributable to owners of the Company	1,523	1,190	261	123	5	(130)	2,972
Profit from ordinary operations attributable to rights that do not grant control	-	-	-	125	(1)	(125)	(1)
Total assets attributable to operations at December 31, 2010	6,368	4,990	1,106	1,206	85	186	13,941
Total liabilities attributable to segment of operation at December 31, 2010	6,390	2,440	404	4,314	22	(6,167)	7,403

* The Group companies that are companies providing services (as opposed to manufacturing companies), do not manage a dedicated price system, which differentiates between fixed and variable costs. The above distinction was made for purposes of this report only. Variable costs are costs for which the companies have flexible management and control in the short-term and which directly affect output, compared with fixed expenses, which are not flexible in the short term and do not directly affect output.

** Details of adjustments to consolidated – Transactions between segments of operation and transactions in multi-channel television.

1.5.3 2008:

	Domestic fixed line communications	Mobile radio telephone	International communications, Internet services and NEP	Multi-channel television	Others	Adjustments to consolidated**	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Total revenues:							
From externals	5,179	4,448	1,243	1,506	31	(1,506)	10,901
From other segments of operation in the corporation	319	265	63	7	44	(584)	114
Total income	5,498	4,713	1,306	1,513	75	(2,090)	11,015
Total costs attributable to:							
Variable costs attributable to segment of operation*	1,785	1,849	622	555	53		
Fixed costs attributable to segment of operation*	2,238	1,931	442	781	22		
Total costs	4,023	3,780	1,064	1,336	75	(1,903)	8,375
Costs that do not constitute revenue in another segment of operation	3,743	3,614	928	1,222	73	(1,212)	8,368
Costs that constitute revenue in other segments of operation	280	166	136	114	2	(691)	7
Total costs	4,023	3,780	1,064	1,336	75	(1,903)	8,375
Profit from ordinary operations attributable to owners of the Company	1,475	933	242	88	(1)	(97)	2,640
Profit from ordinary operations attributable to rights that do not grant control	-	-	-	89	1	(89)	1
Total assets attributable to operations at December 31, 2010	6,281	4,644	994	1,132	100	1,163	14,314
Total liabilities attributable to segment of operations at December 31, 2010	6,037	2,552	284	4,024	29	(2,856)	10,070

* The Group companies that are companies providing services (as opposed to manufacturing companies), do not manage a dedicated price system, which differentiates between fixed and variable costs. The above distinction was made for purposes of this report only. Variable costs are costs for which the companies have flexible management and control in the short-term and which directly affect output, compared with fixed expenses, which are not flexible in the short term and do not directly affect output.

** Details of adjustments to consolidated – Transactions between segments of operation and transactions in multi-channel television.

For explanations about the development of the financial data shown in Sections 1.5.1 – 1.5.3, see Section 2 of the Directors' Report on the State of the Company's Affairs.

1.5.4 Main results and operational data

Condensed data showing the results of each of the Company's main segments of operation in 2009 and 2010:

A. Bezeq Fixed-line (the Company's domestic communications segment)

	2010	2009	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Revenues (NIS millions)	5,263	5,303	1,329	1,323	1,307	1,304	1,316	1,343	1,318	1,326
Operating profit (NIS millions)	2,043	1,523	494	556	503	490	161	491	434	437
Depreciation and amortization (NIS millions)	690	794	178	171	171	170	194	184	205	211
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	2,733	2,317	672	727	674	660	355	675	639	648
Net profit (NIS millions)	1,426	1,107	340	377	349	360	136	319	316	336
Cash flow from current operations (NIS millions)	2,140	2,220	540	684	523	393	651	526	408	635
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	1,032	853	302	245	247	238	220	204	191	238
Receipts from the sale of property, plant and equipment and intangible assets (NIS millions)	132	86	43	48	26	15	9	19	9	49
Free cash flow (in NIS millions)*	1,240	1,453	281	487	302	170	440	341	226	446
Number of active subscriber lines at the end of the period** (in thousands)	2,365	2,489	2,365	2,395	2,425	2,458	2,489	2,518	2,547	2,579
Average monthly income per line (NIS) (ARPL)***	81	82	83	82	81	80	82	83	81	81
Number of outgoing minutes (in millions)	10,883	12,196	2,668	2,675	2,764	2,775	2,964	3,096	3,014	3,123
Number of incoming minutes (in millions)	6,547	6,718	1,644	1,665	1,634	1,623	1,674	1,731	1,659	1,654
Number of Internet subscribers at the end of the period* (in thousands)	1,066	1,035	1,066	1,056	1,051	1,045	1,035	1,026	1,016	1,011
Rate of subscribers using NGN services out of total Internet subscribers (%)	34%	12%	34%	27%	23%	17%	12%	8%	3%	1%
Average monthly revenue per Internet subscriber **** (NIS)	75	69	78	76	72	73	70	70	67	67
Average bandwidth per Internet subscriber (Mbps)	4.3	2.7	4.3	3.8	3.4	3.0	2.7	2.5	2.4	2.3
Churn rate*****	12.5%	12.0%	3.4%	3.1%	3.1%	3.0%	3.0%	3.0%	2.8%	3.2%

* Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.

** Inactive subscribers are subscribers whose Bezeq lines have been physically disconnected (except for a subscriber during (roughly) the first three months of the collection process)

*** Excluding revenues from transmission and data communication, Internet services, services to communications operators and contract and other works: calculated according to average lines for the period

**** Total revenues from Internet services after eliminating revenues from a business directory, divided by the average Internet subscribers. Until September 30, 2010, average revenue was calculated without eliminating revenue from the business directory. In light of the change in the definition of Internet services for purposes of calculating the ARPU as aforesaid, the data for the period to September 30, 2010 (inclusive) were recalculated and are shown in the above table in accordance with the updated definition.

*****The number of telephony subscribers who left Bezeq Fixed-line during the period, divided by the average number of registered subscribers in the period.

B. Pelephone

	2010	2009	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Revenue from services (NIS millions)	4,550	4,256	1,145	1,159	1,140	1,106	1,086	1,101	1,050	1,019
Revenues from sale of terminal equipment (NIS millions)	1,182	1,120	323	283	289	287	307	271	296	246
Total revenue (NIS millions)	5,732	5,376	1,468	1,442	1,429	1,393	1,393	1,372	1,346	1,265
Operating profit (NIS millions)	1,383	1,190	343	356	362	322	251	316	321	302
Depreciation and amortization (NIS)	601	603	154	149	149	149	158	155	151	139
Operating profit plus depreciation (EBITDA) (NIS millions)	1,984	1,794	497	505	511	471	410	471	472	441
Net profit (NIS millions)	1,033	875	268	239	267	259	181	231	233	230
Cash flow from operating activities (NIS millions)	1,219	1,115	91	400	378	350	55	395	290	375
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	397	559	92	99	114	92	101	146	163	149
Free cash flow (in NIS millions)*	822	560	(1)	301	264	258	(45)	249	131	226
Number of subscribers at the end of the period (thousands)**	2,857	2,766	2,857	2,825	2,807	2,789	2,766	2,721	2,694	2,669
Average number of minutes per subscriber per month (MOU)***	349	333	364	347	348	336	339	339	329	323
Average monthly revenue per subscriber (NIS) (ARPU)****	135	132	134	137	136	133	132	136	131	128
Number of HSPA subscribers at the end of the period (thousands)	1,325	676	1,325	1,160	1,005	845	676	471	283	117
% revenues from value added services and content out of revenue from cellular services	23.8%	19.6%	25%	24.5%	23.0%	22.6%	20.8%	20.0%	19.1%	18.5%
Subscriber churn rate*****	15.3%	13.8%	3.9%	3.5%	3.9%	3.9%	3.4%	3.8%	3.3%	3.3%

* Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.

** Subscriber data do not include subscribers connected to Pelephone services for six months or more but who are inactive. An inactive subscriber is one who in the past six months has not received or made at least one call or who has no paid for Pelephone services.

*** Average monthly use per subscriber (in minutes) is calculated by the average monthly total outgoing minutes and incoming minutes in the period, divided by the average number of subscribers in the same period.

**** Average monthly revenue per subscriber is calculated by dividing total revenues from cellular services (airtime, usage fees, call completion fees, roaming fees, value added services, and other), repair and other services in the period, by the average number of active subscribers in the same period.

***** The churn rate is calculated at the ratio of subscribers who disconnected from the company's services and subscribers who became inactive during the period, to the average number of active subscribers during the period.

C. Bezeq International

	2010	2009	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Income (NIS millions)	1,380	1,318	350	347	340	343	334	332	327	324
Operating profit (NIS millions)	320	261	65	70	124	62	67	66	68	60
Depreciation and amortization (NIS)	94	84	25	23	23	23	23	21	21	20
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	414	345	90	93	147	84	89	88	88	80
Net profit (NIS millions)	253	200	46	53	107	46	49	51	56	44
Cash flow from operating activities (NIS millions)	292	320	92	75	66	59	72	82	83	84
Payments for investments in property, plant and equipment and intangible assets (NIS millions)*	180	120	80	30	33	37	39	33	26	21
Free cash flow (in NIS millions)**	112	200	12	45	33	23	33	48	57	62
Churn rate***	12.7%	14.8%	3.5%	3.2%	2.9%	3.2%	3.9%	3.4%	3.6%	3.9%

* The item also includes long-term investments in long-term assets.

** Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.

*** The number of Internet subscribers who left Bezeq International during the period, divided by the average number of registered Internet subscribers in the period.

D. <u>DBS</u>

	2010	2009	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Income (NIS millions)	1,583	1,530	400	395	396	391	390	380	376	384
Operating profit(NIS millions)	178	248	41	72	7	59	63	61	59	66
Depreciation and amortization (NIS)	285	234	85	68	68	64	63	59	56	57
Operating profit before depreciation (EBITDA) (NIS millions)	463	482	126	140	75	122	126	120	115	122
Net profit (loss) (NIS millions)	(314)	(222)	(84)	(78)	(143)	(8)	(38)	(88)	(95)	(1)
Cash flow from operating activities (NIS millions)	488	410	131	126	109	121	91	135	93	91
Payments for investments in property, plant and equipment and intangible assets (NIS millions)*	278	262	90	64	63	61	53	87	60	61
Free cash flow (NIS millions)**	211	149	42	63	46	61	38	48	33	29
Number of subscribers*** (at the end of the period, in thousands)	578	571	578	575	573	571	571	567	562	560
Average monthly revenues per subscriber (ARPU)**** (NIS)	230	226	231	229	231	229	229	224	224	228
Churn rate*****	13.0%	13.3%	3.1%	3.3%	3.1%	3.5%	3.2%	3.3%	3.1%	3.7%

* This item also includes investments in the cost of subscriber acquisition.

** Cash from operating activities less purchase of property, plant and equipment and intangible assets, net.

*** Subscriber – one household or small business customer. Where a business customer has many reception points or many decoders (such as a hotel, kibbutz or gym), the number of subscribers is calculated by dividing the total payment received from the business customer by the average revenue per small business customer.

**** Monthly ARPU is calculated by dividing total DBS revenues (from content and equipment, premium channels, technical service, advanced products, one-tom sale of content, revenues from channels, Internet and other)by average number of customers.

*****Number of DBS subscribers who left DBS during the period, divided by the average number of DBS registered subscribers in the period.

1.6 Group forecast

The Bezeq Group estimates that despite the expected decline in revenues as a result of the reduction in cellular interconnect fees,[15] net profit and EDITDA in 2011, will be similar to those of 2010 after eliminating the effects of the provision of NIS 281.5 million for early retirement which is expected to be recorded in the first quarter of 2011, and after eliminating an anticipated expense of NIS 120 million for the new employee stock option plan which is expected to be recorded over the course of 2011.[16]

The Bezeq Group is continuing to invest in the NGN network, and expects that its coverage will reach 85% of households in Israel by the end of 2011.[17] The Group's gross capital expenditures in 2011 are projected to be between 5% and 10% higher than in 2010, primarily due to Bezeq International's deployment of a submarine cable that, upon its completion, is expected to significantly enhance the group's internet bandwidth capacity and connectivity to the world wide web. The group is considering the possibility of purchasing real estate that will serve as the group's headquarters, replacing leased properties. If the group decides on this alternative, its gross capital expenditures in 2011 would increase by an additional 5% to 10%.[18]

The Company's forecasts in this section is forward-looking information as defined in the Securities Law, based on the Company' assessment of, among other things, the structure of competition in the communications market and the applicable regulation, the economic situation in the country as w whole, the Group's ability to execute its plans for the coming year, the changes in implementation of the employee retirement plans, and the Company's investment in infrastructure. Actual results might differ significantly from the above, if any of the assessments is not realized or if one of more of the risk factors described in Sections 2.21, 3.24, 4.22 and 5.22 are not realized.

1.7 General environment and influence of external factors on the Group's activities

The communications industry around the world and in Israel is characterized by rapid development and by frequent changes in technologies, in the business structure of the industry and in applicable regulation. Below is a description of the main trends and central characteristics of the communications industry in recent years, which have significantly affected the operations of the Group as a whole.

1.7.1 Forming of communications groups in the Israeli market and transition to competition among the groups

One of the main trends that has characterized the Israeli communications market in recent years us the forming of a number of communications groups consisting of companies under joint control that operate in different segments of the communications market,[19] as shown in the following table and its footnotes:

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15 See Section 1.7.3.

16 See Section 2.9.7C.

17 See Section 2.7.2.

18 See Section 2.7.4E.

19 For this matter, "group" is characterized by joint control even though in some of the groups there is corporate, accounting or marketing separation of the entities comprising the group.

Group / Activity	Bezeq	IDB [(a)]	Partner [(b)]	Hot – Mirs[(c)]
Cellular telephony	Pelephone	Cellcom	Partner	Mirs
Fixed-line telephony	Bezeq	Cellcom Netvision	Partner 012 Smile	HOT Telecom
Internet services (fixed-line / cellular	Bezeq Pelephone Bezeq International	Cellcom Netvision	Partner 012 Smile	HOT Telecom HOT-Net
International calls	Bezeq International	Netvision	012 Smile	-
Multi-channel television	(DBS)[20]	-	-	HOT Broadcasts

a. **IDB Group** – To the best of the Company's knowledge, IDB Group provides communications services through Cellcom and Netvision, which are public companies under joint control. Cellcom provides cellular telephony services (including cellular Internet), fixed-line telephony mainly to business customers on its own infrastructure, transmission and data communication services for business customers through its own transmission network, and ISP services. Netvision provides ISP services, international call services and fixed-line telephony services using VoB technology. In September 2009, Cellcom and Netvision announced that they were in very preliminary stages of reviewing the possibility of combining their businesses, but to the best of the Company's knowledge at the date of this report, no announcement of an actual combination has been made.

b. **Partner Group** – To the best of the Company's knowledge at the date of this periodic Report, Partner Group provides communications services through Partner, a public company. Partner provides cellular telephony services (including cellular Internet), fixed-line telephony, transmission and data communications, and ISP services. On March 3, 2011, Partner announced that it has closed a transaction from October 2010 to purchase the shares of 012 Smile, an ISP, international telephony services and fixed-line telephony services in VoB technology. According to the Ministry of Communications announcement, its approval of the acquisition of 012 Smile by Partner was conditional upon 012 Smile's international call operation being managed separately from Partner's cellular services, subject to limitations of structural separation set in the regulations of an international operator license, until the earlier of the date on which a Mobile Virtual Network Operator (MVNO) starts operation in Israel or until the end of 2012. On amendment of the International Operator License Regulations in this matter, see also Section 4.17.6A.

c. **HOT-Mirs Group** – To the best of the Company's knowledge, HOT-Mirs Group provides communications service through HOT and through Mirs, which is controlled by Mr. Patrick Drahy, the controlling shareholder in HOT.[21] HOT-Mirs Group owns a cable infrastructure which is deployed nationwide, and it provides multi-channel television services though HOT, as well as fixed-line telephony services. The group has Internet infrastructure and provides transmission and data communications services through HOT Telecom. Mirs provides cellular communication services using iDEN technology (and in February 2011 it submitted its bid in a tender for UMTS frequencies – see Section 3.1.9D). In December 2009, HOT-Net was granted an ISP license, subject to structural separation limitations between HOT-Net and HOT and HOT Telecom, and limitations on marketing joint service bundles that include HOT-

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20 As noted in Section 1.1.2, the Company does not control DBS and following the decision of the Supreme Court in 2009, it is forbidden to control DBS. For the purpose of this report, DBS is shown as part of Bezeq Group even though it is not controlled by Bezeq.

21 It is noted that according to reports issued by HOT, in October 2010 a company controlled by the controlling shareholder in HOT entered into transactions which, if closed, would increase the holding of the controlling shareholder in HOT to more than 50%.

Net's Internet access (among the limitations are an obligation to market bundles that correspond to competing ISPs, and an obligation to sell the ISP services separately and on the same terms as they are sold when part of the bundle (unbundling).

While in the past the competition in the communications market was mainly among independent communications services providers in each segment separately, more recently and especially in the reporting period the trend has been to competition among communications groups. In some cases, the groups operate on the basis of marketing cooperation among the various communications providers in the group so as to provide full communications services, extracting every last marketing and operational advantage embodied in such a structure, while in other cases where there is no cooperation of this kind, they might be created in the future in view of the control links between the companies and taking into account also the changing regulatory policy in the industry.

More recently there has been an increase in the consumption of "service bundles" (packages containing various communications services such as telephony, Internet and broadcasts). This trend is strengthening with the transition to technologies based on IP protocol, which promotes technology convergence between the different communications systems and with the start of penetration of integrated products enabling various communications solutions on the same handset (e.g. cellular and fixed-line telephony services in one handset. Communications groups market, or are likely to market in the future, "joint" service bundles consisting of different communications services of the companies in each group. As a rule, the marketing of the joint bundle enables the communications group to offer its customers tariffs that are more attractive than purchasing each service separately (in some cases with "cross-subsidization" among the bundle's components), and a total solution that does away with the need to be subscribed to a number of different providers.

Unlike the other groups, Bezeq Group is subject, at the date of this report, to the stricter limitations described below.

1.7.2 Activities of Bezeq Group as a communications group and the structural separation restriction

At the date of this report, the Group is subject to a number of regulatory limitations relating to the formation of joint ventures among the Group's companies. These limitations challenge the Group to provide an appropriate response to the threats of intensifying competition from the other communications groups.

A. Structural separation

The Domestic Carrier license states that the Company must maintain structural separation between itself and its subsidiaries.[22] This framework includes complete separation of the companies' managements, including business systems, the financial system and the marketing system; complete separation of assets; a ban on the Company hiring employees of a subsidiary and vice versa; restrictions on the appointment of a Company employee[23] as a director in a subsidiary, and a ban on the transfer of commercial information to a subsidiary (including in relation to the Company).

The structural separation limitations put the Group in an inferior competitive position compared with the other communications groups, which are not subject to such far-reaching limitations, and give rise to high management overhead.

On the recommendations of the Hayek Commission on March 3, 2011 which were presented for public response, including recommendations concerning th cancellation of structural separation, see Section 1.7.3.

B. Easing of structural separation – Limited approval for marketing joint bundles

Until recently, the structural separation limitations prevented the Company from marketing joint service bundles. Following the decline of the Company's market share

[22] Pelephone, Bezeq International (including the merged Goldnet partnership), DBS and Bezeq On Line.

[23] Except for chairman of the board.

to below 85%.[24] in May 2010 the Company was permitted to offer private subscribers joint service bundles with the subsidiaries, subject to approvals by the Ministry of Communications and other conditions laid down in the Domestic Carrier license, including these:

1. The bundles must be able to be unbundled, meaning that a service included in them will be offered separately and on the same terms.
2. At the time of submitting a request for approval of a bundle, there is a group of services in similar format being marketed to a private subscriber as a package by a license-holder who is not a subsidiary of the Company, or there is a group that includes license-holders who provide a private subscriber with all the services included in the joint service bundle.

Joint service bundles marketed by the subsidiaries and which include the services of the Company, are also subject, according to their licenses, to similar limitations, including unbundling (except for a bundle marketed by a subsidiary that contains only the Company's Internet infrastructure service).

These limitations, and in particular the unbundling obligation, which severely limits the Group's ability to offer discounts on the components of the bundle, put the Group in a competitively inferior position compared to the competing communications groups which are not subject to similar limitation in marketing joint bundles (other than a limitation on marketing a joint bundle of HOT-Net and other companies in HOT Group, as noted in Section 1.7.1).

At the date of this report, the Company may market joint service bundles to the private sector only, Since the Company's market share in the business sector declined to below 85% in September 2009, the Company has requested that the Ministry of Communications amend its Domestic Carrier license so as to enable it to market joint bundles also to business customers. On February 3, 2011, the Ministry of Communications sent a draft amendment to the communications licenses of the group companies that will enable them to market joint service bundles in the business sector under the same limitations.

C. Other limitations on offering benefits to Group companies and joint ventures among them

Other limitations on cooperative ventures between the Company and Group companies stem from various provisions applicable to them, both under antitrust laws and conditions laid down by the Antitrust Commissioner in approvals of mergers between the Company and Group companies, which prohibit discrimination in favor of Group companies when providing certain services (see Section 2.16.8), and by virtue of the provisions of the Company's license, which oblige it to provide its services equally to all.

If the final recommendations of the Hayek Commission on the cancellation of structural separation, subject to the terms of its cancellation being similar to the recommendations presented to the public, and if they are adopted, then the principles applicable to the Company in this matter will change significantly – se Section 1.7.3.

D. Ban on control of DBS

The Company holds 49.78% of the shares of DBS,[25] with the balance held by Eurocom DBS which is (indirectly) controlled by Mr. Shaul Elovitz, who indirectly controls the Company.[26] In light of the structure of the holdings in DBS, cooperative ventures between it and Group companies (such as agreements for mutual marketing

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[24] The permit to market joint bundles was granted (by way of amendment of the Domestic Carrier license) pursuant to the policy paper published by the Minister of Communications in 2004, which stated that after the Company's market share in a particular segment (private or business) falls below 85%, it will be allowed to market joint service bundles with the subsidiaries in the same segment. The Company's market share in the private sector (according to the method of calculation determined by the Ministry of Communications for this matter) fell below 85% in 2008, and in the business sector in September 2009.

[25] As well as options exercisable for additional shares in DBS – see Section 1.1.1.

[26] On placing these shares in trust under irrevocable power of attorney in accordance with the terns laid down in the transaction for acquisition of control in the Company – see Section 1.3.1A.

of products and services) must currently be approved as transactions in which the controlling shareholder in the Company has a personal interest (see Section 5.19), in a way that could impede the business flexibility of the Group in such cooperative ventures.

In view of the position taken by the Antitrust Commissioner and the ruling of the Supreme Court in 2009 (see Section 2.16.8G), the Company refrained from increasing its holdings in DBS or controlling it, in a way that limits the Group's ability to benefit fully from the advantages which could have stemmed from the inclusion of DBS in the Group. If in the future these regulatory limitations and structural separation and the other limitations applicable to cooperative ventures between the companies in the Group are removed, then the options open to the Company to increase its holdings in DBS or to control it could create opportunities for the Group to utilize synergies with DBS or facilitate the utilization of such synergies. It is emphasized that a the date of this report, existing regulation does not allow the Company to increase its holdings in DBS or to control it.

Recommendations under consideration by the Hayek Commission which were presented to the public for its remarks on Match 3, 2011, include, among others, a recommendation to cancel the structural separation in the multi-channel television segment upon fulfillment of certain terms (see Section 1.7.3).

1.7.3 Regulatory oversight and changes in the regulatory environment

Communications in Israel in general and the activities of the Company in particular, are subject to extensive regulation and close supervision. The principal body overseeing the activities of the Group is the Ministry of Communications.[27] Regulation of the communications market in Israel is characterized by frequent changes, mainly aimed at increasing competition in the industry.

Considering the diversity of the Group's communications operations, regulatory developments could, in certain cases, have different effects on different areas of operation in the Group, meaning that changes in regulation that adversely affect one area, could potentially have a positive effecting another area (see for example, the effects of the reduction of interconnect fees for the cellular network in sub-section c. below). In certain cases, opposing effects on the areas of operation might be offset one against the other at the Group level.

Below is a description of some of the main regulatory developments in the reporting period and in recent years, which affect a material part of the areas of operation of the Group.

A. Policy for regulating competition

Gronau Committee

The policy of the Ministry of Communications for the principles of competition in communications was outlined in the Gronau Report and in the letter of the then Minister of Communications concerning adoption of the report, with a number of changes (**"the Competition Policy Documents"**). The Competition Policy Documents laid down a number of principles relating to the Group's activities, among them these:

1. Wholesale market of fixed-line infrastructure – The wholesale market in the fixed-line segment must be developed, with the prime goal being dismantling into sections. Owners of universal infrastructures (the Company and HOT) will be required to ell services wholesale (e.g. resale – wholesale purchase at a reduced price from the owner of the infrastructure by a communications operator and retail marketing to end users), and the leasing of access sections to competitors (Unbundling Local Loop), which for reasons of technological applicability it was determined would apply at this stage only to the Company). It was also determined that the Ministry of Communications would start working on

[27] In July 2010, the Ministry of Communications distributed the Israel Communications Authority Law Memorandum, 2010, describing the establishment of a communications authority which would be the main regulatory body for communications in Israel, both in telecommunications and in broadcasts, which would be vested with the powers of the Ministry of Communications, the Second Authority, the Second Authority Council and the Satellite Broadcasts Council.

preparation of the regulatory and pricing basis required for establishing the wholesale market. Among other things, the Hayek Commission was set up for this purpose.

2. Sale of packages that cannot be unbundled by the subsidiaries – It was recommended that after implementation of the wholesale market arrangement, the subsidiaries of the Company would be granted a permit to provide service bundles that cannot be unbundled (i.e. bundles in which the individual services cannot necessarily be purchased on the same terms as those at which they are offered in the bundle).

3. Flexibility in the approval of alternative tariff packages for the Company – See Section 2.16.1.

4. Promotion of grant of MVNO licenses to virtual cellular operators – See Section 3.7.2B.

5. Structural separation – It was decided to enforce structural separation on HOT Group (nevertheless, the license of HOT Telecom was amended in June 2009 and exceptions were determined to the structural separation obligation between it and HOT Broadcasts) and to leave the structural separation in Bezeq Group as long as there are only two companies that own a nationally-deployed fixed-line infrastructure.

6. Entry of cellular operators into the international calls arena – See Section 4.17.6A.

7. Lowering the rate of royalties – A gradual lowering of the rate of the royalties applicable to license-holders was decided upon, until their eventual future cancellation. If taxes are reduced in the years 2008-2012, the royalties will be cancelled. Cancellation of the royalties should be accompanied by a corresponding reduction in tariffs. On the raising of the rate of royalties contrary to this recommendation – see sub-section b. below.

Hayek Commission

On March 28, 2010, the Ministers of Communications and Finance appointed the Hayek Committee to review and revise the structure of the Company's tariffs and to set wholesale service tariffs and call completion tariffs in the fixed-line networks. In the letter of appointment, the Committee was requested to make recommendations in the matter of setting the base level of telecommunications tariffs and how they would be calculated, a tariff control mechanism, tariff updates including an efficiency factor and mechanisms for the prevention of cross-subsidization among the various services, based on the cost of the services.

In addition, and with the approval of the Minister of Communications, the Chairman of the Committee would be able to discuss other topics not included in the letter of appointment. The Minister of Communications approved the Committee's discussion of structural separation in the communications market, and the question of tariff control – its format and its necessity, and the communications project of Israel Electric Corporation (see Section 2.6.4C).. On February 12, 2011, the Hayek Commission sent a request to the Company for data to enable it to examine the costs of components in Domestic Carrier networks.

On March 3, 2011, the Hayek Commission invited the public to submit positions to the Committee by March 22, 201, on the Committee's recommendations on structural matters in the communications industry. The structural recommendations in the document constitute, according to the Committee's letter, conditions for implementation of the detailed arrangements that would then be formulated by the Committee. The main points:

1. Structural separation – Compulsory structural separation in fixed-line and other areas of the communications industry would be cancelled, except for the structural separation in multi-channel television, which would be cancelled after operation in the television market is enabled on the Internet infrastructure.

2. **Tariffs** – Control of the Company's wholesale tariff would be by setting a maximum tariff. It is proposed that this arrangement will take effect immediately, irrespective of any other topic referred to in the document. The Committee is also considering removal of the control by means of setting tariffs and a transition to control by virtue of Section 17 of the Communications Law,[28] and to do so gradually. On the control applicable today to the Company's tariffs, see Section 2.16.1.

3. **Providing service and enabling use of infrastructures** – Holders of general Domestic Carrier licenses will provide service and allow use of all the infrastructures required to enable other license-holders to provide service for end-users (among them, passive infrastructure, transmission lines in various technologies, and others).

   Broadband access service will be provided immediately, in a way that enables the service provider that does not have its own infrastructure to manage the service. The infrastructure provider will be required to provide everything needed beyond the line itself, so as to permit the transparency needed for control and management of the service.

4. Holders of general Domestic Carrier licenses will reach agreements with other license-holders for the use of the types of services referred to in sub-section 3 above. The agreements will be forwarded to the regulating entity and will be made known to the public.

5. In the absence of agreement between the parties and to the extent required, the regulating entity will intervene to put in place the arrangements that the Committee intends to formulate

6. Holders of general Domestic Carrier licenses will regularly inform other license-holders of the deployment of the existing infrastructures.

7. The Committee attributes great importance to the advancement of the communications company on the infrastructure of Israel Electric Corporation ("IEC") (see Section 2.6.4) and to the terms of implementation of cancellation structural separation as described in sub-section 1 above. The Committee believes that the regulatory principles for providing wholesale services should be applied equally to the entity that will be established as part of this initiative, and to other general Domestic Carrier license-holders. On amendment of the government decision and approval for the establishment of a communications company, see Section 7.6.4.

8. The cancellation of structural separation is conditional upon and will be implemented immediately upon fulfillment of the following terms:

   - Implementation of sub-sections 3, 4 and 7.
   - After the elapse of six months from the date on which agreements as referred to in sub-section 4 are signed, or from the date on which the holders of general Domestic Carrier licenses start to provide the wholesale services as provided in those agreements – the earlier of the two dates.
   - Deposit of autonomous bank guarantees in significant amounts(hundreds of millions of shekels) by general Domestic Carrier license-holders, for assuring the existence of a wholesale market.

9. Failure to comply with one or more of these principles will result, inter alia, in a regimen of close control, the imposition of personal liability on the managers of companies that hold general Domestic Carrier licenses, forfeiture of the guarantees, an obligation for structural separation between the infrastructure of the license-holder and the services provided to the end-users.

The Committee intends to formulate detailed recommendations for these arrangements and to present them to the Ministers of Communications and Finance after receiving and hearing the remarks of the public, for application of the principles described above. Remarks and positions submitted to the Committee will be published on the Ministry of Communications website.

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[28] Section 17 of the Communications Law states that "For a telecommunications service for which no payment is determined under Section 15, a license-holder may demand reasonable payment."

The Company, which is studying the recommendations published for remarks by the public, believes that the recommendations that are adopted by the Hayek Commission could materially influence the Group, even though they are difficult to assess before their adoption. Moreover, the Company sees a lack of clarity in some of the detailed arrangements that will be formulated by the Committee. The effects of the Committee's recommendations also depend largely on the balance that will eventually be given to various factors in the recommendations and in their detailed explanations. For example, development of a wholesale market and imposition of the duty to break up the fixed-line network into sections, could have a significantly adverse effect on the Company. Conversely, if recommendations are adopted concerning the cancellation of structural separation, such factors would have far-reaching and positive implications for the Group and its results. With regard to a change in the tariff control mechanism, it is difficult to assess its implications before the final format is decided, although in certain conditions it could impact positively on the Company.

The Company's assessments with regard to the effects of the Hayek Commission's recommendations on the Group's operations and results are forward-looking information. They are based, inter alia, on the structure of competition in the communications market, on the recommendations included in the Policy Documents and their actual application, and on the request for the public's positions as noted above. These assessment might not be realized or might be realized in significantly different ways than foreseen, inter alia depending on the final recommendations that will actually be made by the Hayek Commission, on how their implementation will affect the Group and how they will affect its competitors, on changes in the structure of competition in the market and the regulation applicable to it. As already mentioned, at this stage, when recommendations concerning structural separation have been presented to the public for its remarks but the final recommendations have not yet been received or adopted and the Company believes that clarification is needed for those recommendations, the Company s unable to estimate the full effect of the recommendations on the Group.

B. Increase in the rate of royalties

The Communications Law states that a holder of a license for providing telecommunications services shall pay royalties to the State out of its revenues from providing the services named in the Regulations. The Royalties Regulations impose of a general Domestic Carrier licensee (which includes the Company), an international call service license (which includes Bezeq International) and a cellular licensee (which includes Pelephone), a duty to pay royalties on its revenues (excluding VAT) from the services listed in the Schedule to the Regulations. Over the years the royalties were lowered to 1% per year commencing 2010. Furthermore, the Royalties (Satellite Broadcasts) Regulations impose on a satellite broadcasts licensee (DBS) a duty to pay royalties at the rate of 1$ of its taxable income.

However, on January 19, 2011, a temporary order was published stating that the royalties to be paid by a general Domestic Carrier licensee (excluding a special Domestic Carrier) and a cellular licensee would be raised to 1.75% in 2011 and to 2.5% in 2012. The temporary order would remain in force until the earlier of December 31, 2012 or the date on which the terms laid down in the temporary order have been met.[29] On February 28, 2011 the Company petitioned the High Court of Justice against this temporary order.

In addition, in January 2011 the Knesset Finance Committee approved an amendment to the Royalties (Satellite Broadcasts) Regulations so that in 2011 and 2012 the rate of royalties would be 1.75% and 2.5% of taxable income respectively, and would revert to 1% commencing 2013 or on the date when the terms laid down in the Regulations are met.[30]

[29] With regard to a general Domestic Carrier licensee (excluding a special Domestic Carrier licensee) – in a case where a general licensee that receives its license in 2001 or later deploys infrastructure to 5% of the population; for a cellular licensee – in a case where (1) a cellular operator started providing domestic roaming services, or (2) the MVNO market share is less than 5% (see Section 3.1.9).

[30] The date on which the Director General at the Ministry of Communications publishes a notice in the Official Gazette stating that seven channels will be added to the DTT array (see Section 5.1.4A).

For details about the amounts of royalties that Group companies paid in 2009 and 2010, see Sections 2.16.4, 3.18.4, 4.17.4 and 5.17.1.

C. Change in interconnect tariffs to the cellular networks

The Interconnect Regulations set the interconnect tariffs to be paid to the Domestic Carrier, as well as limitations for the matter of the interconnect tariffs to be paid to a cellular operator. In September 2010 the regulations were amended so that commencing January 1, 2011, the interconnect tariffs that a cellular carrier can collect from other operators (Domestic Carrier, international call operator or another cellular operator) were lowered significantly. Below are the interconnect tariffs to a cellular operator that were in force in the past, and the tariffs after the amendment:[31]

	March 1, 2010 – December 31, 2012	2011	2012	2013	2014 onwards
Call minute completion tariff	25.1	6.87	6.34	5.91	5.55
SMS (text) completion tariff	2.85	0.16	0.15	0.14	0.13

* The tariffs are in agorot and do not include VAT.

The effect of the change in the interconnect fees on the Group companies is not yet reflected in the Group's financial statements, and in the Group's assessment that effect is not uniform –

<u>In the Company's domestic communications segment</u> – The Company charges its customers interconnect fees in the phone bill for calls originating in the Company's network and terminating in the cellular networks, and pays the cellular operators the same amount for transferring call traffic in their network.

Below are data on the Company's revenues in fixed-line domestic communications from subscribers in interconnect fees to the cellular network, and its expenses in respect of call completion fees to the cellular companies in 2008 – 2010 (in NIS millions):

	2010	2009	2008
Income / expenses	801	823	893

In the cellular segment (Pelephone) – Pelephone pays the other cellular operators interconnect fees for calls originating in the Pelephone network and terminating in their cellular networks (expense side), while the other operators (cellular, domestic and international) pay Pelephone interconnect fees for call terminating in its cellular network (income side).

Below are data for Pelephone's revenues from interconnect fees received from other communications networks in respect of incoming text messages (SMS) to the Pelephone network, and its expenses in respect of interconnect fees to the other cellular networks in 2008 – 2010 (in NIS millions).

	2010	2009	2008
Income	1,054	920	895
Expenses	813	707	678

In the international calls segment (Bezeq International) – Bezeq International pays interconnect fees to the cellular operators for calls terminating in their cellular networks.

Pelephone believes that overall, reduction of the tariffs could lower its revenue from interconnect fees beyond the amount by which the expense is lowered, since the source of part of the decrease in revenue from interconnect fees lies in the lower revenue from non-cellular operators who prior to the change paid interconnect fees at a higher rate than after the change. Furthermore, it could be that reduction of the

[31] The tariffs, which are denominated in agorot, will be revised every year on January 1st and linked to the index (the base index being the average CPI for 2009), and both VAT and the rate of royalties applicable to cellular operators under the Royalties Regulations multiplied by the indexed interconnect tariff, will be added.

interconnect fees will lead to a rise in the volume of calls from the fixed-line networks at the expense of calls from cellular handsets, and therefore a further decrease in Pelephone's revenues (see below). In view of this assessment, Pelephone expects the reduction in the fees to have a materially adverse effect on its results.

Nevertheless, the Company believes that in its operations as a Domestic Carrier, the reduction in interconnect fees could be positive for the Company, especially since the lower fees it pays to the cellular companies is rolled over onto the customer,[32] inter alia in light of the expected increase in calls originating in its fixed-line network due to that reduction and the resulting less costly fixed-line calls. In addition, Bezeq International estimates that the reduction of the interconnect fees could be positive for its results, but this is not material at the Group level.

The Company believes that the positive effects foreseen for the results of the Group in domestic communications and international calls will partially offset the negative effects on expenses in the cellular services segment (Pelephone), and accordingly, the overall adverse effect of the reduction on the Group's results will not be material.

The assessments of the Company, Pelephone and Bezeq International with regard to the effects of the reduction in interconnect fees to the cellular network on Bezeq International, on Pelephone, on the Company and on the Group, as the case may be, are forward-looking information as defined in the Securities Law. These assessments are based, inter alia, on the market share and scope of operations of the Company and of Pelephone (including the assumption that the reduction in interconnect fees will lead to a rise in the number of fixed-line calls), on the existing tariff structure, on the structure and regulation of competition in the market, and on customer behavior. There is no certainty that the market shares and scope of operations of the Group will be the same as or similar to its assessments, or that the reduction in interconnect fees will lead to an increase in calls fixed-line calls or the rate of such increase. These assessments might not be realized, night be partially realized or realized in a way that differs significantly from projections.

D. Limitation of the exit penalty a license-holder can collect from a subscriber

On February 13, 2011, the Ministry of Communications distributed a Law Memorandum – Communications (Amendment No. 47) (Limitation on payment and loss of benefit due to cancellation of an agreement) Bill, 2011, in which it is proposed to apply provisions to communications license-holders as listed in the Memorandum, which are similar to those applied to the cellular companies in the matter of limiting the exit commission that a license-holder can collect from a subscriber (see Section 3.7.2D). According to the memorandum, the payment that a license-holder is allowed to collect from a subscriber who cancels the communications agreement will be limited to 8% of the average monthly bill of the subscriber up to the date of cancellation, multiplied by the number of months remaining at the end of the term of the commitment. A license-holder will also be forbidden to demand immediate payment of the balance of the subscriber's payments for the terminal equipment in the event of cancellation of the agreement. According to the Memorandum, it will apply also to existing subscribers who request to cancel the agreement with the license-holder after the amendment comes into force.

Under the Memorandum, these provisions will apply, inter alia, to Domestic Carriers (including the Company), to international call operators (including Bezeq International), and to broadcasting licensees (including DBS).

The Company, Bezeq International and DBS believe that if the proposed amendment is adopted, it could increase the churn rate of subscribers in their areas of operation. This assessment is forward-looking information as defined in the Securities Law, which might not be realized or realized in a way that differs significantly from the way foreseen, inter alia, depending on the conditions that will be laid down in the amendment (if adopted) and on the scope of its application to subscribers.

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[32] Revenues from interconnect fees that the Company collects from its customers for calls to a cellular telephone are set off against payments that the Company makes to the cellular companies for interconnect fees in respect of those calls.

For a description of other regulatory developments in the reporting period and of the main limitations application to the areas of operation of the Group, see Sections 2.16, 3.18, 4.17 and 5.17.

1.7.4 Level of economic activity in Israel

The activities of the Group are influenced by the level of economic activity in Israel, and accordingly, a change for the better or worse in that level can be expected to affect the Group's business.

2. Bezeq – Domestic fixed-line communications

2.1 General information about the segment of operation

2.1.1 The segment of operation and changes occurring in it

The Company holds a general license for providing domestic fixed-line communication services and provides a range of such services as described in Section 2.2, principally these: domestic fixed-line telephony (landline telephony), Internet access infrastructure services, and transmission and data communication services.

2.1.2 Legislative limitations and standards and special constraints

A. Communications laws and the Company's Domestic Carrier license

The Company's operations are subject to government regulation and comprehensive supervision that stem from the Company's status as a general license-holder under the Communications Law, to the provisions of the Communications Law and its concomitant provisions, regulations and principles, and to the provisions of the Domestic Carrier license and of other laws.

In addition, the Company was declared a provider of essential telecommunication services under the Communications Order. Pursuant to that declaration, the Company is obliged to provide a number of basic services under the Domestic Carrier license, and may not terminate them or narrow them without approval. The order also lays down limitations on the transfer and acquisition of means of control in the Company, and certain limitations on the activities of the Company. For details, see Section 2.16.3.

The Company's tariffs for most of its domestic fixed-line services are subject to control under the Communications Law and the provisions of its Domestic Carrier license. For details, see Section 2.16.1.

The Domestic Carrier license lays down additional limitations on the Company's activities (see Section 2.16.2), the main ones being these: (1) a duty to provide universal service, i.e. to provide its services to everyone, without discrimination; (2) structural separation – see Section 1.7.2; (3) a duty to provide interconnect services for other communications license-holders on reasonable and equal terms; (4) various limitations concerning the quality and terms of the services the Company provides, a duty to pay royalties, and others.

For the recommendations of the Hayek Commission on March 3, 2011 as published for the remarks of the public, including in the matter of tariff control, cancellation of structural separation and the terms for doing so, provision of services and options for use of the Company's infrastructures by other license-holders, and intervention of the regulating body – see Section 1.7.3.

In addition, the Company is required to obtain approval from the Ministry of Communications for providing new communications services and service bundles. This limitation could make it difficult for the Company to develop various services in response to various technological developments, and could also harm the speed of its response to changes in the activities of its competitors.

B. Antitrust laws

The Company was declared a monopoly in the main areas of its activities,, and is also subject to supervision and to limitations under the Antitrust Law (see Section 2.16.8).

C. Environmental laws and planning and construction laws

In addition, some of the activities of the Company involve the use of wireless frequencies and the use of facilities that emit electromagnetic radiation, which are subject, respectively, to the Telegraph Ordinance (see Section 2.16.9), the Non-Ionizing Radiation Law (see Section 2.15), and to UBP 36 and UBP 56 (see Section 2.16.11).

2.1.3 Changes in the scope of operation in the segment, and its profitability

For the principal data about the scope of operation in domestic fixed-line communications and its profitability in 2009 and 2010, see Section 1.5.4A. Below is a description of the main changes in the scope of operation in the segment in the reporting period.[33]

A. Fixed-line telephony – In 2010, a decrease f 5% was recorded in the number of lines and of 8% in the volume of average call minutes (incoming and outgoing) on the Company's fixed telephone lines compared with 2009. This followed the rising trend in the pace of removal of fixed lines and the decrease in the volume of fixed-line calls recorded in recent years, which stems, so the Company believes, from the rise in calls from cellular telephones and calls over the Internet (see Section 2.1.4), and from competition with other Domestic Carriers. No significant change has occurred in the average monthly revenues from a telephone line.

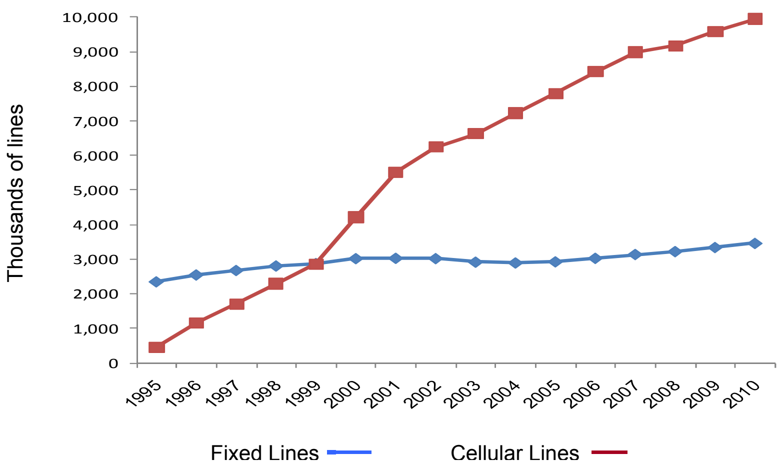
B. Internet access – In 2010, a rise of about 3% was recorded in the number of the Company's Internet subscribers, and of about 9% in the average monthly revenue per Internet subscriber, compared with 2009. The Company believes that the increase in revenues in this area stems from a rise in the speeds offered in the surfing packages (see Section 2.2.3) and the adoption of advanced services and value added applications.

2.1.4 Market developments and customer characteristics

A. Domestic fixed-line telephony services

In he past few years, fixed-line telephony has been characterized by a decline in demand and in prices. The decline in demand is reflected in the gradual erosion of the number of calls originating in the fixed-line networks. The Company believes that this trend stems primarily from the rise in the number of cellular subscribers and the volume of use of cellular telephones (the Company estimates that about two-thirds of calls originate in the cellular network).

Figure 1 – Changes in the number of fixed telephone lines compared with cellular telephone lines in Israel, 1995-2010[34]



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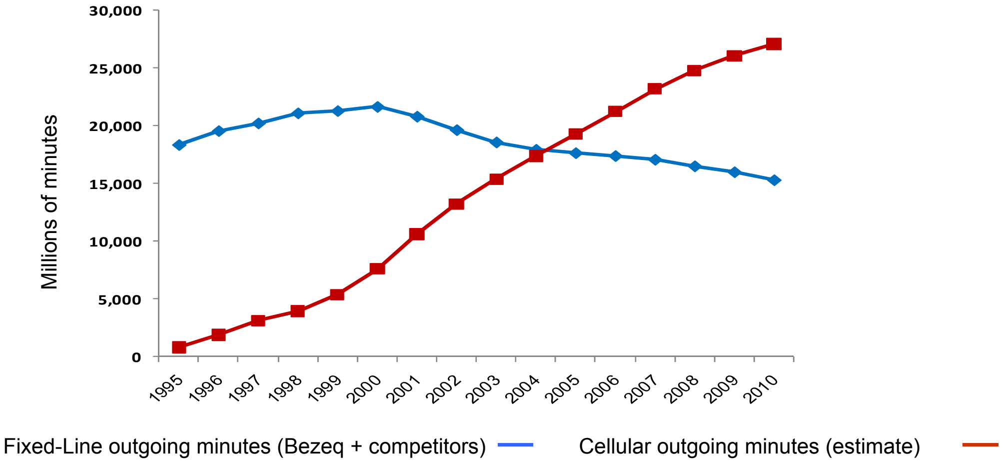
[33] For detailed data and definitions of subscriber and average income, see the notes to the table in Section 1.5.4A.

[34] The data are based on a Ministry of Communications publication on cellular lines, the reports of HOT to the public and assessment about the other operators. Accordingly, some of the data in the figure are based on estimates and the actual data might be different.

Figure 2 – Changes in the number of call minutes from fixed-line telephones compared with the number of call minutes from cellular telephones in Israel, 1995-2010[35]



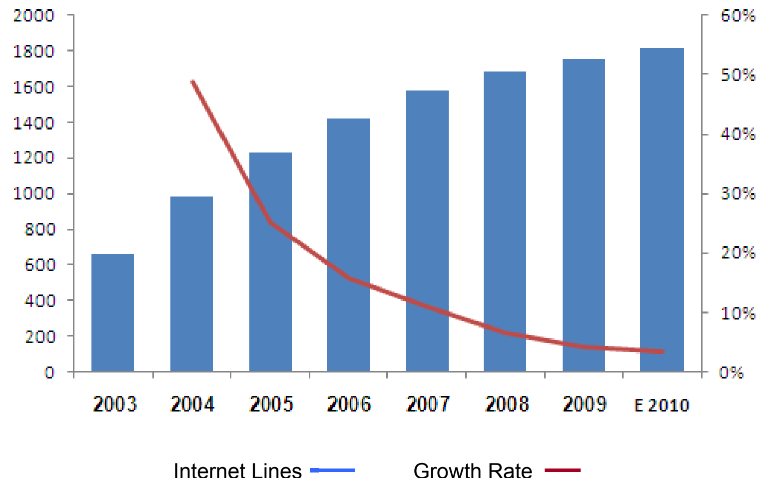
In the matter of reduction of interconnect fees to the cellular networks and the Company's assessment as to their effect on the volume of calls originating in the Company's telephony network, see Section 1.7.3.

In addition, in recent years the volume of call over the Internet has been increasing, which also reduces the number of call made in fixed-line networks.

B. Internet access infrastructure services

In the Internet segment, while growth has been recorded in recent years in terms of the number of customers, the rate of that growth is slowing over time as a result of the high Internet penetration rate in Israel. Nevertheless, the Internet segment is characterized by a rise in surfing speeds and by the adoption of advanced services and value added applications.

Figure 3 – Changes in the number of Internet lines and the internet growth rate, 2010-2013[36]



In 2009, the Company launched its NGN (Next Generation Network) and HOT launched its UFI network. These networks enable surfing at considerably higher speed

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[35] The data are based on a Ministry of Communications publication on cellular lines, the reports of HOT to the public and assessment about the other operators. Accordingly, some of the data in the figure are based on estimates and the actual data might be different..

[36] The data for 2003-2009 are based on Company data and Hot reports to the public. The data for 2010 are based on Company data and assessments as to the volume of active lines of HOT, which has not yet published its financial statements Therefore, some of the data are based on estimates and the actual data might be different.

than were available until then. It is noted that a considerable number of Company customers who are connected to the NGN are upgrading their surfing speeds t these new levels. For details, see Section 2.2.3.

On the possible establishment of a competing fixed-lime network on the Company's infrastructure, on the electricity grid, see Section 2.6.4C.

C. Transmission and data communication services

The transmission and data communications segment for business customers and communications providers is characterized by a rapid increase in the customers' broadband consumption, but in general by lower prices per given volume of traffic. This stems both from development of the technology allowing greater bandwidth at lower prices than in the past, and from competition in this area (see Section 2.6.3).

D. Service bundles

On the increase in consumption of service bundles, see Section 1.7.1.

On the development of competition in domestic fixed-line communications, see Section 2.6.

For the recommendations of the Hayek Commission on March 3, 2011 as published for the remarks of the public, including in the matter of tariff control, cancellation of structural separation and the terms for doing so, provision of services and options for use of the Company's infrastructures by other license-holders – see Section 1.7.3.

2.1.5 <u>Technological changes that can materially influence the segment of operation</u>

A. The ongoing trend of increasing bandwidth and the availability of technologies based on IP protocol, allow the customer a broader range of applications and services on IP-based infrastructures, such as telephony services, video transfer services, network services with organizational applications on the Internet infrastructure (ERP, CRM, etc).

B. These changes are leading to an increase in the demand for bandwidth by Company customers of Internet infrastructure, transmission and data communication. The Company is deploying its NGN in a way that enables it to provide its customers with greater bandwidths (see Sections 2.6.6 and 2.7.2).

Conversely, the technological developments that enable IP-based telephony services are one of the factors that have led to the decline in the consumption of the Group's fixed-line telephony services (on competition in telephony by providing services over the Company's Internet infrastructure (VoB), see Section 2.6.1.

C. The increase in the capacity of the cellular network along with technological improvements, allow the cellular operators to compete with the Company's telephony services and more recently also with its Internet services, and to market larger bandwidths to their customers at lower prices. In the past year the trend of growing numbers of cellular Internet users has continued (see Section 2.6.2). At the date of this report, the Company estimates the increase in cellular Internet consumption has not materially affected the volume of its Internet usage. Nevertheless, the growth potential of the cellular networks at the expense of the Company's market share is a real one.

D. In addition, wireless technologies (such as WiMAX)are being developed, which enable the provisions of services that compete with the Company both in telephony and in data communication and the Internet, without need for heavy investments in land-based access infrastructures.

E. Technological developments and falling prices of the equipment could enable other operators to provide services similar to those provided by the Company at much lower cost.

F. It is possible that a communications company will be established with a fixed-line infrastructure that competes with that of the Company, based on the IEC's electricity grid (see Section 2.6.4C.).

2.1.6 Critical success factors in the segment and the changes in them

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

B. Regulatory decisions.

C. The ability to maintain innovation and technological leadership and to translate them into advanced and reliable applications of value to the customer at short response times, and marketing primacy.

D. Preservation of brand values and their adaptation to the conditions of the changing competitive environment.

E. Effectiveness of the sales arrays and the internal and external distribution channels.

F. The ability to provide a high-quality commercial and technical service.

G. Managing an intelligent price policy, subject to regulatory limitations, in light of the intensifying competition and technological changes that are reflected in erosion of the general price level in the industry.

H. Informed moving of customers away from traditional networks to new generation networks.

2.1.7 Principal entry and exit barriers of the segment of operation, and changes occurring in them

Operating in the domestic fixed-line communications segment requires receipt of the appropriate Domestic Carrier licenses.

Traditionally, the main entry barrier to this segment stemmed from the need for heavy investment in technological infrastructure and in surrounding systems until obtaining economies of scale, and from high costs involving the establishment of marketing, sales, collection and customer support systems and the building of a brand. In recent years, these traditional carriers to the Company's segments of operation have lessened considerably as a result of the following factors: technological improvements, lower infrastructure and equipment prices, easing of regulation granted to new competitors, and the ability to use existing set-ups, including the Company's network, by competing communications carriers or those destined to compete with the Company.

The regulation of competition in VoB-based telephony, which enables telephony services to be provided on a broadband infrastructure of another operator without need for an independent line telephony infrastructure (and in the future, if it becomes possible, competition based on dividing the network into sections and wholesale sale of services – see Section 1.7.3), significantly reduces the size of investment required from those competing with the Company, thereby making the entry barriers to the segment much smaller.

The main exit barriers stem from the commitment of the Company laid down in its license to provide its services to a defined quality and universally (to the entire public in Israel), its subordination to the provisions of the Communications Order, the regulations accompanying the Communications Law, and the provisions by virtue of Section 13A of the Communications law relating to emergency operation, its commitment to those of its employees who are employed under collective agreements, long-term agreements with infrastructure suppliers, the large investments requiring time before seeing a return, and the commitment to the repayment of long-term loans taken to finance the investments.

2.1.8 Substitutes for segment products and changes occurring in them

Cellular communications services are a substitute product for the Company's services, both in telephony and in Internet (see Sections 2.6.1 and 2.6.2).

IP technology such as VoB (see Section 2.6.1) and the Internet are also substitutes for the Company's services. In Internet services, transmission and data communications, technological developments (e.g. G4 in cellular, infrastructure based on optical fibers, including by means of the electricity grid and advanced cable Internet protocols), enable the provision of new services at high speeds and competitive prices.

2.1.9 The structure of competition in the segment and changes occurring in it

Domestic fixed-line telephony is regulated and controlled by the Ministry of Communications, inter alia by means of granting licenses to entities operating in the segment.

Until 2004, the Company was the only provider of fixed-line telephony services in Israel. HOT telecom started operation in telephony 2004. Subsequently, the Ministry of Communications granted licenses to other entities, which included licenses with no duty to provide universal services (i.e. no obligation to offer services to the entire public in Israel).

Fixed-line telephony is characterized by a lively competitive dynamic. The Company's competitors are HOT Telecom, VoB service providers (Cellcom, 012 Smile, Netvision, Partner and Bezeq International), and also, the Company believes, the cellular companies (see Section 2.6.1).,

Over the past year, the trend of VoB service providers to recruit customers has strengthened. These providers have operated for several years under license with no obligation to provide universal service, and without their own independent access infrastructure, most of them being entities related to providers of Internet access services (ISP) and international communications services, while some are the cellular companies (See Section 1.7.1).

The Internet segment is typified by high penetration rates, which are attributed at least partially to the high level of competition between the Company and HOT Telecom, both owners of a nationwide access infrastructure (HOT Telecom started operation in its area in 2002), and among the ISP companies. Here, the Company is also exposed to competition from the cellular companies (see Section 2.1.5).

Transmission and data communication opened up to competition at the end of 2000, and among its operators are HOT telecom, Cellcom and Partner.

Competition in the industry depends on a number of factors, such as regulatory decisions, possible changes in the terms of the licenses of the Company and the subsidiaries and the terms of the licenses of their competitors, mergers and joint ventures between companies that compete with the Group companies, financing universal services, the new services that the Company has been permitted to provide, tariff policy, and the extent of flexibility allowed to the Company when offering service bundles, including with the subsidiaries.

For a description of the development of competition, see Section 2.6.

For the recommendations of the Hayek Commission dated March 3, 2011 which were published for the public's comments, see Section 1.7.3.

2.2 Products and services

2.2.1 General

The Company provides a wide range of communications services for its business and private customers, as described below.

2.2.2 Telephony

The Company's telephony services include mainly the basic telephony service on the domestic telephone line, plus associated services such as voice mail, caller ID, call waiting, call forwarding, speed dial, and conference calls.

The Company also provides its customers with a national numbering services for businesses (1-800, 1-700), for full or partial payment for the calls by the business.

The Company currently operates about 12,500 public telephones around he country, which are operated by various types of cards.

The Company operates a unified telephone directory[37] at the code (1344) determined by the Ministry of Communications for fixed-line and cellular telephony operators, as well as a unified website which is free of charge, in addition to the Company's 144 service. At the end of 2009, the Ministry of Communications published a request for positions of the public in the matter of the need for and format of opening number information services to competition, by way of having these services provided by entities other than telephony operators or those acting on their behalf or by way of canceling the Company's 144 code. The Company opposed the proposed alternatives. At the date of this report, the position of the Ministry of Communications on the matter has not yet been published.

The Company's telephony services are its main services, and in recent years have been characterized by a decline in consumption and revenues, mainly die to the competition from the other fixed-line telephony service providers and the cellular companies. At the end of 2010 the Company had 2,365,000 active telephone lines (compared with 2,489,000 at the end of 2009). For details about change in the number of active lines and average monthly revenue per line, see Section 1.5.4A. For details about the Company's market share in this segment, see Section 2.6.1.

As part of its marketing strategy, the Company is working on the development and penetration of new services, both in the private sector and in the business sector. The Company plans to continue to launch more products on the basis of market trends and customer needs.

2.2.3 Internet access infrastructure services

The Company provides broadband Internet access infrastructure services in xDSL technology.

At the end of 2010, the Company had 1.066,000 Internet subscribers (compared with 1,035,000 at the end of 2009). At December 31, 2010, the percentage of Internet subscribers connected to the NGN was about 52% of total Internet subscribers, and the percentage of subscribers using NGN services (those with packages of 10 mbps or higher) was 18% of all Internet subscribers.

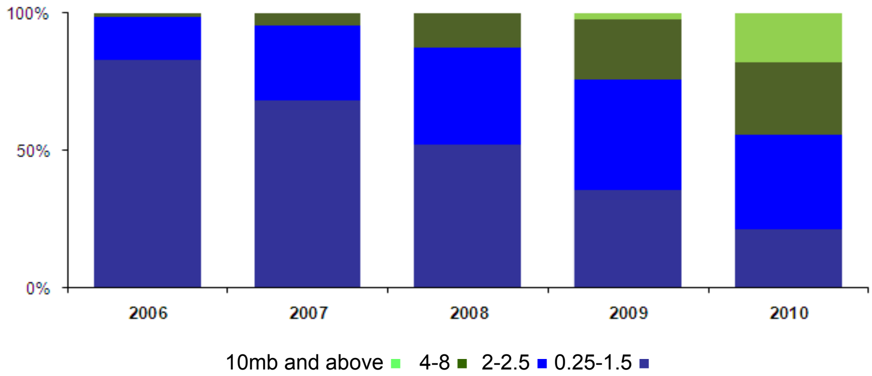
For details about changes in the number of the Company's Internet subscribers and average monthly revenue per Internet subscriber, see Section 1.5.4A. For details about the Company's market share in this segment, see Section 2.6.2.

The Internet market has been one of the fastest growing markets of recent years (although a slower pace of growth has been seen compared with a rise in requested bandwidth – see Section 2.1.4B), and this service has become on of the main occupations of the Company and a central channel for its investments in technology, marketing, advertising and customer acquisition and upgrades.

The average surfing speed of the Company's Internet subscribers at the end of 2010 was 4.3 mbps, compared with 2.7 mbps at the end of 2009.

[37] A "unified" directory service is an information service containing data on the subscribers of all the operators. Fixed-line and cellular telephony operators are obliged under the terms of the licenses to provide unified information services.

Figure 4 – Changes in the surfing speeds of the Company's Internet subscribers, 2006-2010 (in Mbps at the end of each year)



Furthermore, the Internet market is characterized by lively competition with HOT, and more recently with the cellular companies, which offer cellular surfing services (see Section 2.6.2).

2.2.4 Transmission and data communication services

Data communication services are network services for transferring data from point to point, transferring data between computers and between various communications networks, services connecting communications networks to the Internet, and remote access services.

Data communication services are provide on a traditional and long-standing infrastructure such as Sifranet and frame relay, on an ATM infrastructure, and on newer and advanced infrastructures such as IPVPN and Metro Ethernet. The IPVPN infrastructure enables managed communications solutions for businesses with connection between the branches of the organization. The Metro Ethernet infrastructure enables the provisions of communications infrastructure services in Ethernet technology for services to the business and private sectors. In recent years a trend has developed of customer transition from data communications solutions in the traditional infrastructure to IP-based infrastructures (such as IPVPN) and Ethernet (such as Metro Ethernet). The transition enables the Company to offer its customers larger transfer capacities at lower prices, and demand is increasing.

The Company offers transmission services, including a high speeds, to communications operators and its business customers in a range of interfaces (see Section 2.6.3). For details about the notice of the Ministry of Communications to the Company concerning ostensible violation of the provisions of the Domestic Carrier license in connection with providing transmission services for the Domestic Carriers Cellcom and Partner, see Section 2.6.2.

For the recommendations of the Hail Committee dated March 3, 2011 which were published for the public's comments, including in the matter of providing services and enabling use of the Company's infrastructures by other license-holders – see Section 1.7.3.

2.2.5 Other services

A. Services to communications operators

The Company provides services for other communications operators, such as cellular operators, international call operators, cable broadcast license-holders, NEP operators, ISPs, Domestic Carriers, and Palestinian communications providers.

Among the services provided by the Company are infrastructure services, connection to the Company's network, transmission services, billing services, leasing of space, and services in leased premises and grant of usage right in undersea cables.

For the recommendations of the Hayek Commission dated March 3, 2011 which were published for the public's comments, see Section 1.7.3.

B. Broadcasting services

The Company operates and maintains radio transmitters which are operated, inter alia, by Israel Broadcasting Corporation, the television broadcasts of Channel 1 and

Educational Television, the television broadcasts of Channel 2, and the broadcasts of a number of regional radio stations. It also operates the DTT transmitters. The Company is responsible only for operating and maintaining the transmitters, and not for the content of the broadcasts – see also Section 2.15.

C. Contract works

The Company caries out set-up and operation works of networks or sub-networks for various customers *e.g. the Ministry of Defense, HOT, radio and television broadcasting companies, cellular operators, international call operators, local authorities, municipalities, and government bodies).

The Company has agreements with HOT Telecom for providing installation and maintenance services of the cable networks in the Company's infrastructures, from the exit point of the operation of the license-holders to the delivery point at the entrance to the homes of the subscribers (the connection and maintenance from these points to the subscribers' homes themselves are not the responsibility of the Company).

D. IP Centrex – IP Centrex service is a private and virtual exchange service in a public network.

E. Data Center – A service enabling a backup and survivability solution for the customer.

F. 144 Internet site (B144) – A search engine for finding the telephone numbers of businesses and private persons, including a classified search.

G. New services – Among other things and in addition to launching its NGN (see Section 2.7.2), the Company has launched new services such as Bphone (a service enabling telephone calls to be made through the Internet as calls made from a fixed-line phone), on-hold music, storage services in the network, and home exchange services.

2.3 Breakdown of product and service revenues

The table below shows data for the breakdown of the Company's revenues by principal product and service in its segment of operation, 208-2010 (in NIS millions).

	2010	2009	2008
Revenues from line telephony	3,160	3,333	3,572
Percentage out of total Company income	60.04%	62.85%	64.97%
Revenues from Internet infrastructure services	977	863	790
Percentage out of total Company income	18.56%	16.27%	14.36%
Revenues from transmission and communication services	882	851	811
Percentage out of total Company income	16.76%	16.04%	14.75%
Revenues from other services	244	256	325
Percentage out of total Company income	4.64%	4.84%	5.92%
Total income from domestic fixed-line communications services segment	5,263	5,303	5,498

2.4 Customers

The Company is not dependent on a single customer or small number of customers, the loss of which would materially affect the segment of operation, and there is no customer which accounts for 10% or more of the Company's total revenue.

The Company's sales are divided into two main customer types – private (about 60%), and business (about 40%). The division is by revenues, as shown in the following table:

(NIS millions)	2010	2009	2008
Revenues from private customers	3,128	3,165	3,303
Revenues from business customers	2,134	2,138	2,195
Total revenues	**5,263**[38]	**5,303**	**5,498**

[38] It is noted that the difference between the cumulative amount of revenues from private customers and revenues from business customers and total revenues shown in the table, stem from the rounding of the amounts.

2.5 Marketing, distribution and service

The Company has marketing, sales and service arrays for its business and private customer, which include customer managers for the business sector, combined sales and service centers (including Moked 199) around the country, technical support centers for private and business customers, as well as 16 points of sale and service (Bezeqstores) at various locations.

The Company markets its services mainly through advertising in the mass media and telephone sales centers, customer managers and an array of independent dealers which are mainly ISPs, and sales centers that operate by the outsourcing method.

2.6 Competition

Below is a description of the development of competition in the domestic fixed-line communications segment.

2.6.1 Telephony

The Company believes that at the end of 2010, its market share in the fixed-line telephony market was approximately 65% in the private sector and 78% in the business sector. , compared with 72% and 82% at the end of 2009 in those two sectors respectively.[39]

The competition in the fixed-line communications segment is lively:

A. Competition from other Domestic Carrier license-holders

The Company and HOT Telecom both own nationally-deployed fixed-line telephony infrastructure and they are in lively competition which is reflected, inter alia, in the marketing of service bundles combining Internet infrastructure, telephony and cable television aimed mainly at households (for the marketing of service bundles of Bezeq Group, see Section 1.7.2). In addition, HOT markets telephony services to business customers.

The Company also has competition from six license-holders for domestic fixed-line communications services, including VoB (see Section 2.1.9).

B. Competition in telephony from the cellular companies

The penetration rate of cellular telephony in Israel is among the highest in the world at 127% (see Section 3.1.4). In the opinion of the Company, this penetration rate combined with low airtime rates on an international scale, have made the cellular telephone a product that largely substitutes for the landline telephone. The Company believes that a deepening of this substitution of the fixed line is one of he causes of the growing removal rate of telephone line (see Section 2.1.3).

Partner and Cellcom also provide fixed-domestic fixed-line services through corporations they own, and they sell service bundles that combine fixed-line and cellular telephony and Internet services. On the transaction for the acquisition of 012 Smile by Partner, see Section 1.7.1B.

C. Regulation of VoC services

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[39] These market shares are in terms of lines, based on the Company's assessment. It is noted that the Ministry of Communications publishes data based on its own calculations for the Company's market share, in terms of normative income (a calculation that was relevant in the past for checking the decline in the Company's market share to below 85% for the purpose of granting a permit for the Company to sell joint bundles – "the First Measurement Method"), and data calculated by the Ministry in standard (individual) lines in terms of normative income and PRI trunks (a calculation designed for determining the discount brackets permitted with the approval of alternative tariff packages based on the Gronau recommendations – see Section 2.16.1 – "the Second Measurement Method"). The Company's position is that these methods have become irrelevant since the Company's market share fell below 85% in the private and business sectors, and fell below 70% (for the matter of granting discounts in tariff packages). According to Ministry of Communications publications, these methods showed that in October 2010 the Company's market share was 71.7% in the private sector and 80.7% in the business sector using the First Measurement Method and 70.5% in individual lines and 74.3% in PRI trunks by the Second Measurement Method.

On December 17, 2010, the Ministry of Communications announced a hearing on the matter of setting regulation policy for VoC services (telephony services on the cellular Internet infrastructure), which will examine the regulation of these services under a license for cellular operators and virtual operators (MVNO) and/or as part of a special VoB domestic operator license. In response to the hearing, the Company noted that VoC service is indeed the continuation of VoB service, both of which are provided over the Internet and the Company wishes to provide it. The Company believes that marketing VoC services under a VoB license, if allowed, can be expected to increase competition in telephony, and will enable telephony services to be provided at fixed-line call prices on the cellular network.

2.6.2 Internet infrastructure segment

The Company believes that at the end of 2010, its market share in the Internet infrastructure market was approximately 59%, similar to the end of 2009.

The competition in this field is also lively:

A. Competition from HOT Group – HOT's Internet infrastructure is deployed nationwide (and was recently upgrade to UFI (Ultra Fast Internet) network), in which a range of communications services and interactive applications can be provided. The network is currently the main alternative to competition with the Company in the private sector., The upgrading of the infrastructure and grant of an ISP license to HOT-Net in December 2010 (see Section 1.7.1C), are expected to increase the level of competition in Internet and could also increase the number of HOT customer who subscribe to service packages.

B. Competition from cellular operators – The cellular companies have deepened their Internet activities on the cellular range both n the private sector and in the business sector. Unlike the fixed-line communications segment (where the provision of access infrastructure services – by HOT, is separate from provision of Internet access services – by the ISP) , the cellular Internet service is provided as one unit. Surfing services are provided both from the cellular handset and through a cellular modem that connects laptop and desktop computers in combination with Internet access services. On the matter of a hearing on the subject of regulation of the broadband market structure in the cellular network, see Section 3.7.2C).

2.6.3 Transmission and data communications

The companies operating in this field are Cellcom, Partner (which acquired the Med-1 operation), HOT, and Internet companies that also use leased infrastructures.

To the best of the Company's knowledge, Cellcom has deployed and set up a transmission network which it uses both for its own needs (instead of transmission provided for it in the past by the Company) and for competition with the Company in the transmission and data communications market. Cellcom offers its customers a complete package of solutions that includes domestic telephony, data communication and cellular communication, using its own infrastructure and its own sales array. Partner has also stepped up its activities in providing transmission and data communication services combined with telephony, for business customers.

Under the terms of its license, the Company is obliged to provide some of its communications services to all. According to Ministry of Communications interpretation of this and other provisions in the Domestic Carrier license in the matter of providing infrastructures services to license-holders, the Company is also obliged to provide infrastructure and transmission services to competing communications operators for providing services which compete with those of the Company. In October 2010, the Ministry of Communications notified the Company that it had violated the provisions of its license by refusing to provide transmission services to the Domestic Operator companies controlled by Cellcom and Partner, and that if the Company did not give notice within 7 working days that it had ceased the violation, the Ministry would be compelled to institute a proceeding for the imposition of financial a sanction or to consider some other action. The Company acted in accordance with the Ministry's decision but demanded the basis and reasons for it. On this matter, see also Section 2.16.8. For the Hayek Commission's request for positions on its recommendations dated March 3, 2011, including on the matter of providing services and enabling use of the Company's infrastructures, see Section 1.7.3.

2.6.4 Additional factors that could influence competition

A. Narrowing of transition barriers among companies

Numbering and number portability – Since 2007, number portability has existed In the fixed-line and cellular telephony market, enabling customers to switch between various communications operators without changing their telephone number. Number portability increases competition, and the Company believes that it has significantly increased the churn rate in its fixed-line telephony services.

Limitation on the exit penalty that a license-holder can demand of a subscriber – See Section 1.7.3D.

B. Other potentially competing infrastructures

In addition to HOT's cable and optical fiber network and the optical fiber infrastructures of Cellcom and Partner, there are today in Israel a number of infrastructures with the potential to serve as communications infrastructures, which are based on optical fibers and are mostly owned by government companies and bodies. Among these are Israel Electric Corporation ("IEC"), Israel Railways, Mekorot (water grid), Oil Infrastructures, and the Cross Israel Highway company. Some municipalities are also trying to create an alternative to pipes being laid by communications license-holders by deploying their own infrastructures.

On July 15, 2010, the Government, during its discussion of the Arrangements Law, decided to instruct the Minister of National Infrastructures and the Minister of Finance to exercise their authority under the Electricity Law, 1996, and to permit IEC (which in 2010 started a technological trial to ascertain its ability to provide a high-speed communications infrastructure by the FTTH method – optical fibers to the customer's home) to operate in communications on certain conditions, mainly these: a "communications company" would be established for use a fixed-line communications infrastructure on the electricity grid; IEC would not hold more than 49% of the means of control in the company and would not control it; the communications company would do business with communications license-holders and not directly with private consumers (except an agreement with Ministry of Communications approval with large business customers, for which it would provide transmission or other services).

On March 7, 2011, the government made a further decision whereby IEC was granted approval to establish the communications company together with another company, which would use and operate the fixed-line communications infrastructure on the electricity grid. In addition, in this decision the government amended its decision from July 15, 2010 (see previous paragraph) so that the communications company would be have to an exclusive right of use for providing telecommunications services only, on the basis of IEC's optical fiber communications infrastructures, in certain volumes and on certain terms. The same decision also states that the financing of that company will be from sources made available by the controlling shareholder and will be selected in accordance with the government's above decision, including by means of raising capital by the company. The decision also makes clear that it does not restrain the discretion of the government to change the decision or prevent the Ministers from exercising their authority under any law.

For the importance that the Hayek Commission attaches to the operation of the communications company on the IEC infrastructure, see the description of the Committee's recommendations published on March 3, 2011 (Section 1.7.3).

In the Company's estimation, of such a communications company is established, which would compete wit the Company in infrastructure, and particularly if that new company is permitted to provide services to operators and business customers without an obligation for universal deployment of an FTTH network or before completing deployment of a significant portion of the network, this could cause significant harm to the operations and the results of the Company.

The Company's assessments of how the establishment of a communications company with a competing infrastructure would affect the Company and its results, are forward-looking information as defined in the Securities Law. It is not certain that a competing communications company will be established, what limitations will be imposed on its activities and what breaks it might be granted. These assessments might not be realized, depending, inter alia, on the question of whether such a company will be established, what restrictions will apply to its activities, and whether any changes will be made to the structure of competition in the communications market.

C. Technological developments

Technological developments enable competing companies to supply, at relatively low costs, telephony and data communications services on OP-based fixed-line networks and by means of advanced cellular infrastructures. The large number of subscribers of the cellular companies and broadband Internet customers, the improvement in broadband audio quality enabled by alternative technologies, are damaging to the number of call minutes in the Company's network and are reducing its revenues from telephony services.

2.6.5 The Company's preparation and ways of coping with the intensifying competition

The Company deals with the competition in domestic fixed-line telecommunications services in several ways:

A. The Company launches new communications services, value added applications and product packages, including terminal equipment and services, in order to broaden the scope of use of subscriber lines, to respond to customer needs and to strengthen its image of technological innovation. The Company invests in enhancement and modernization of its infrastructure so as to enable it to provide advanced services and products for its subscribers. In 2010, upon receipt of the requisite [permit (see Section 1.7.2), the Company started marketing joint products packages, while broadening the supply of the services it offers and offering packages that correspond to some of those offered by its competitors.

B. The Company worked on the penetration of a high-speed internet infrastructure service and on increasing the number of its customers for the service, including by offering applications for businesses. Deployment of the NGN will enable advanced telephony applications to be provided, customer upgrades to higher speeds, and the creation of added value for the customer by means of broader consumption of content, leisure and entertainment applications (see also Sections 2.2.3 and 2.7.2).

C. The Company works constantly to improve the quality of its services and to preserve its customers.

D. The Company has simplified its tariff structure and offers its customers alternative payment packages (see Section 2.16.1), tracks and campaigns.

E. The Company is working to increase awareness of the use of the fixed-line telephone and to encourage the use of other services that increase telephone use.

F. The Company makes adjustments on the expenses side for the purpose of focusing investments on fixed assets in growth activities and in projects for cutting operating costs. Nevertheless, the Company's ability to make adjustments in its expenses in the short and medium term is limited due to the structure of its costs, which are mainly rigid in the short and medium term. These costs include mainly depreciation expenses and expenses related to wages and wage incidentals. In addition, the Company has operating expenses such as infrastructure maintenance and the leasing and upkeep of buildings, which are also rigid in the short term.

G. In selling services to its customers, the Company also sells terminal equipment (home networks, laptop computers, streamers, etc., as well as telephony terminal equipment), as a tool for competitive differentiation, customer retention and increasing its revenues.

2.6.6 Positives and negatives that affect the competitive status of the Company

A. Positive factors

1. Nationally deployed infrastructure through which a range of services are provided.
2. Presence in most businesses and households.
3. Strong and familiar brand.

4. Technological innovation.
5. Strong capital structure and positive cash flows.
6 Broad service infrastructure and varied customer interfaces.
7. Professional, experienced and skilled human resources.

B. Negative factors

The Company believes that various limitations imposed upon it by existing regulation, impede its ability to compete in its areas of operation. The main limitations in this contest are these:

1. <u>Absence of tariff flexibility</u>

The Company is limited in its ability to grant discounts on its principal services and to offer differential tariffs. On this matter, see Section 2.16.1.

For the Hayek Commission's request for positions on its recommendations published March 3, 2011, including in the matter of tariff control, see Section 1.7.3.

2. <u>Structural separation</u>

See Section 1.7.2A. For the Hayek Commission's request for positions on its recommendations published March 3, 2011, including in the matter of cancellation of structural separation and the conditions for doing so, see Section 1.7.3.

3. <u>Duty to provide universal service</u>

The Company operates under an obligation to provide service to the entire public in Israel (universal service). Due to this obligation, the Company could be required to provide services also in circumstances which are not financially viable. This obligation is not imposed on the holders of special Domestic Carrier licenses, which can offer their services to the most profitable of the Company's customers (mainly business customers), which are a material source of the Company's income,

In the opinion of the Company, a fund should be set up for financing universal service, so that an operator that does not provide its services to all and sundry would be obliged to contribute to the fund.

4. <u>"Access deficit"</u>

The Company's telephony tariffs are set in regulations by the Minister of Communications in consultation with the Minister of Finance. As a result of a deliberate regulatory policy, the monthly usage fee tariff for a telephone line is set at a level that does not cover the cost involved in providing it (a situation known as the "'access deficit"). This deficit has been reduced over the years but still exists. It is emphasized that in a competition format that relies on the Company's infrastructure and uses the access deficit (such as VoB service), the negative effects of this factor increases.

5. <u>Limitations in marketing</u> joint services of the Company and other Group companies

See Section 1.7.2B.

6. <u>The nature of fixed-line telephony terminal equipment</u>

Fixed-line terminal equipment is technologically less advanced that the cellular terminal equipment, and the supply of advanced services that can be consumed with it is limited.

2.7 Property, plant and equipment, and facilities

2.7.1 <u>General</u>

The Company's property, plant and equipment consists mainly of domestic communications infrastructure, real estate assets (land and buildings), computer systems, vehicles, and office equipment.

2.7.2 Domestic fixed-line communications infrastructure

PSTN network – This infrastructure has five main components which are deployed throughout the country:

a. Exchanges

These are used for switching and transferring calls from origin to destination according to the signal (dialing) received from the subscriber.

b. Transmission network

A system through which thee exchanges are connected. In practice, the system functions as a national skeleton that connects the local networks, each of which consists of an exchange and an access network to it. The transmission network is based mainly on systems that operate in optical fibers and partly (a very minor part) on radio systems.

c. Data communication networks

Networks for providing data communications services at various speeds and in various communications regimens.

d. Access network

A system that connects between network end points at the customer and the exchange. The network is based on copper pairs, on optical cables and partly (a very minor part) on wireless systems.

e. Terminal equipment

Equipment installed on the customer's premises (e.g. telephone handsets, private exchanges, fax machines, modems, routers, etc.), through which the subscriber receives the service.

NGN

The demand for communications services in Israel and worldwide includes a demand for ever-increasing bandwidths and an advanced IP platform. In order to meet this demand, at the end of 2009 the Company started the gradual set-up of an NGN based on a core IP network and deployment of an optical fiber network to street cabinet (known as fiber to the curb - FTTC). The access network and the terminal equipment in this network are also as described above.

In this network and using VDSL2[40] technology, bandwidth of up to 100 Mbps download speed can be provided, as well as innovative added value services. Other advantages of the new technology are simplification of the network structure and better management ability. The NGN set-up project is a gradual process, with the pace of deployment reviewed and reset annually. The Company launched the NGN in September 2009.For data about the number of subscribers connected to the NGN, changes in the volume of customers who consume NGN services and average bandwidths in 2009 and 2010, see Sections 1.5.4A and 2.2.3.

The Company foresees that by the end of 2011, the NGN will be deployed in about 80% of the country. Accordingly, investment in the network in 2011 is expected to be similar to 2010, while in 2012 the Company foresees a material decrease in investment in the network since ti expects that most of it will have been deployed by the end of 2011. This assessment is forward-looking information as defined in the Securities Law, and is based on the Company's work plans and on the pace of deployment in the past. The assessment might not be realized, inter alia in circumstances of changes in the market structure in Israel and in the demand for the Company's services, significant changes in the costs of deploying the network or in the pace of progress in the set-up project.

On this matter, see also Note 10 to the 2010 Financials.

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[40] Very High Bit Rate Digital Subscriber Line. One of the fastest technologies for data transfer on high bandwidth in standard telephone lines.

2.7.3 Computerization

The computerization array in the Company supports four main areas:

A. Marketing and customer management

The system supports management of a database of the Company's customers, service order management, management of follow-up of customer complaints, management of the sales and service process, application of the number portability plan, and billing. The billing array includes the production of phone bills to the Company's customers for services provided by the Company and for the services of other communications operators. The array also includes the management of accounting with communications operators.

B. Information systems for the engineering infrastructures of the telecommunications networks

These support the planning, management, control and maintenance of engineering resources for the provision and assurance of the services. Inter alia, the systems manage stocks of numbers and support massive changes of numbers and equipment (when necessary).

C. Information systems for management of the Company's resources

These support the management, control and maintenance of the expense side in the Company, the financial information (including budget and control), purchasing and stock processes, property, real estate, human resources and salary control, fleet of vehicles, Company projects, and the like.

D. Company-wide systems

The Company's computerization array is large and complex, and supports critical work processes and handles very large volumes of data. The array consists of a large number of systems, some old, which were developed many years ago and operate on mainframe computers, others modern, developed and applies more recently and operating in open computerization environments.

The systems support decision-making processes by means of a data warehouse operated by the Company. The Company also operates a website which provides information about the Company's services and enables the display of information about the telephone bill, payment of the telephone bill and other services. There are also computerized office systems (e-mail, decision follow-up, etc.), and knowledge management systems.

The Company also develops and assimilates advanced computerization systems, among them a Customer Relations Management system (CRM), engineering network management systems, and service order and supply systems.

2.7.4 Real estate

A. General

The Company's real estate assets are from two sources: assets transferred to the Company by the State in 1984 under the Asset Transfer Agreement (see Section 2.17.2A), and assets in which the rights were purchased or received by the Company after that date, including assets that it leases from third parties.

At the date of publication of this Periodic Report, the Company owns or leases or has right of lease in about 420 real estate properties all over the country. The total area in which the Company has full ownership rights or capitalized lease rights (including joint lease rights as described below) is 1,135,000 sq.m. of land on which the built-up area is about 320,000 sq.m. Six of these properties, with a total area of 7,000 sq.m. and 500 sq.m. built- up, are in Israeli towns in the Administered Territories (of the above total, about 400 properties with an area of 1,020,000 sq.m. of land and 250,000 sq.m. built up, are for communications needs, while the rest are for administrative needs).

In addition, the Company has a right to receive an area of about 70 dunams in Sakia (near Mesubim junction), for warehouses and offices. The Company received a draft contract from Israel lands Administration (the **"Administration"**) which would allow the Company to plan prepare plans for the area that do not include warehouses and offices, and the Company submitted its reservations about the contract to the Administration.

At the date of publication of this report, of the abovementioned properties, 45 are jointly owned with the Ministry of Communications and/or the Postal Authority (now Israel Postal Co. Ltd.). On June 30, 2001, am agreement was signed between the Company and the Postal Authority for defining and regulating the rights of the Company and of the postal Authority in these properties (see Section 2.17.2C). The parties operate as required by the provisions of the agreement, and inter alia they separate joint debits and systems.

In addition to the 420 properties referred to above, the Company holds, at the date of publication of this report, about 60 properties in Israeli towns in the Administered Territories, covering a total area of 9,300 sq.m. of land and about 1,500 sq.m. built up (all for communications needs). There is no written regulation of the contractual rights for these properties, but in the Company's opinion this does not create material exposure.

The real estate assets are used by the Company for communications activities (exchanges, neighborhood rooms, broadcasting sites, etc.) and for other activities (offices, storage areas, etc.). Some of them are undeveloped or partially developed, and can be used for other purposes.

At the date of publication of this report, the Company leases about 195 properties from various landlords, in a total area of about 60,000 sq.m. (about 185 of these properties have a built-up area of 8,000 sq.m. and are for communications purposes, while the rest are for administrative uses).

The Company has an interest (transition rights, etc.) in other real estate (such as for the erection of offices and for laying cables) .Also at the Company's disposal are about 550 neighborhood rooms (for cables and installations used for neighborhood communications), in a total area of 8,310 sq.m. (all for communications purposes).for most of which there is no written regulation of rights with their owners (e.g. the Administration, settlement entities, the entrepreneurs of project in which the properties are located, and house committees).

B. Registration

At the date of publication of this Periodic Report, the Company's rights in a considerable number of its real estate assets are not registered in the Lands Registry, and therefore they correspond to contractual rights. The Company is in the process of registering in its name those properties which can be registered in the Lands Registry.

C. Real estate settlement agreement

On March 10, 2008, a settlement agreement between the Company and the Administration and the State (**"the Settlement Agreement"**) was validated as a court decision. The Agreement concerns most of the real estate that was transferred to the Company in the asset transfer agreement signed prior to the start of the business operations of the Company. The Settlement Agreement states that the assets remaining in the Company's possession have the status of a capitalized lease and subject to the execution of individual lease contacts (at the date of this report, such contracts have been signed for about 60 of the 215 properties for which they are required), the Company would be able to make any transaction in the properties and to enhance them. The Agreement sets out a mechanism for payment to the Administration for enhancement actions in the properties (if undertaken), beyond the rights according to plans approved by 1993 as set out in the Agreement, at the rate of 51% of the increase in value of the property following the enhancement (and less part of amounts paid for a betterment levy, if paid). The Settlement Agreement also states that 17 assets must be returned tom the State, through the Administration, on various dates (up to 2010), and on the terms laid down in the Settlement Agreement.

At the date of publication of this Periodic Report, the Company has returned 15 assets to the Administration, Two others will be returned after the Company receives substitutes properties, as provided in the Settlement Agreement.

D. Sale of real estate assets

Following a new review by the Company's Management concerning the sale of the Company's real estate assets, the Board of Directors approved further sales of assets which are not active and/or which can be relatively easily vacated without incurring significant expenses, in accordance with a list presented to it from time to time. The transition to the NGN allows the Company to increase the efficiency of the network and to sell some of the real estate assets that will be vacated as a result of the transition. During 2010, the Company sold 10 such properties, in a total area of 19,000 sq.m. of land and 15,000 sq.m. built up, for a total consideration of approximately NIS 150 million.

E. Review of investment in real estate as an alternative to leasing

From time to time the Company considers possible investment in the purchase of real estate that would serve as Group headquarters instead of leasing space. At the date of this report, no decision has been made by the Company organs.

2.8 Intangible assets

2.8.1 <u>The Company's Domestic Carrier license</u>

The Company operates under its Domestic Carrier license, which forms the basis for its activities in domestic fixed-line communications (for a description of the main points of the license, see Section 2.16.2).

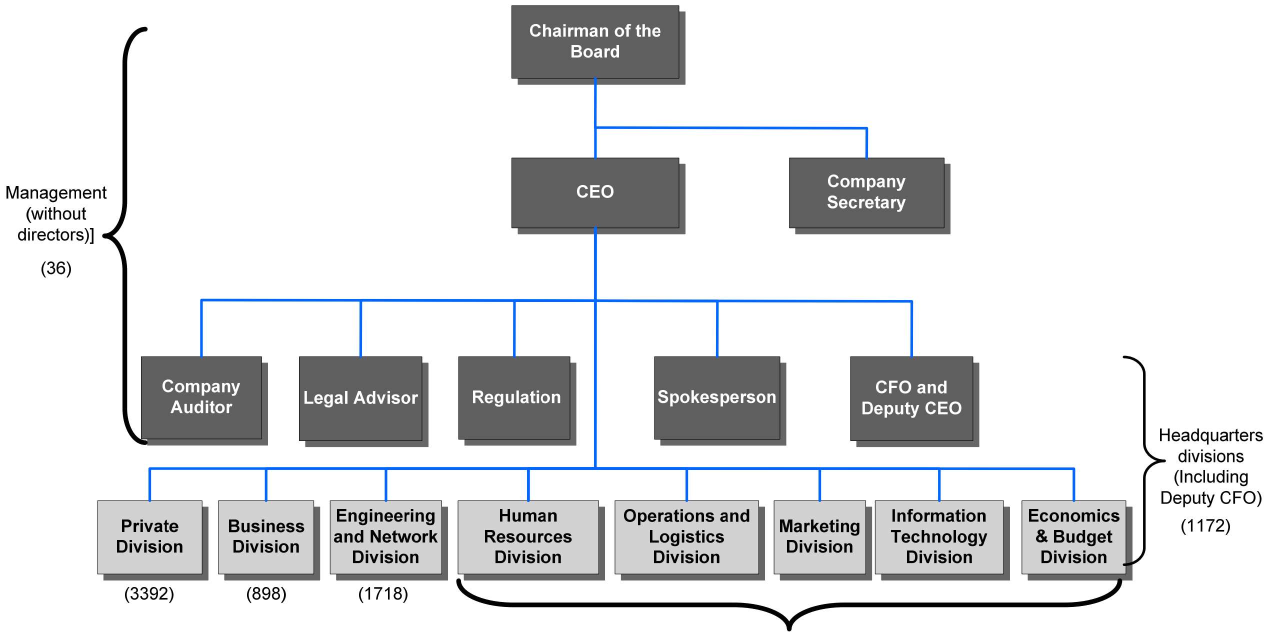
2.8.2 <u>Trademarks</u>

The Company uses trademarks that characterize its services and products. At the date of publication of this Periodic Report, there are about 180 trademarks registered or in the process of being registered in the Company's name with the Registrar of Trademarks. The main trademarks of the Company are **"Bezeq"** – the name of the Company, and **"B"** – the Company's logo. The investment in advertising the trademarks is intended to raise the level of exposure and awareness of the public to the trademarks and to build differentiation and uniqueness for the Company, which will influence the customer purchasing considerations and preference.

2.9 Human resources

2.9.1 Organizational structure and headcount

The chart shows the general organizational structure of the Company:



On September 4, 2007, the Board of Directors of the Company resolved, pursuant to Section 50(a) of the Companies Law and Sections 119 and 1221.1 of the Company's Articles of Association, that the authority of the CEO in all matters relating to corporations held directly or indirectly by the Company (Pelephone, Bezeq International, DBS, Walla, Bezeq on Line and Bezeq Zahav Holdings), would transfer to the Board of Directors, and the Board adopted resolutions accordingly. As a result, on matters relating to the subsidiaries the Deputy CEO and CFO reports to the Board of Directors, while on the Company's activities as Domestic Carrier he reports to the CEO of the Company.

2.9.2 Headcount by employment framework

Description of employment framework	Number of employees	
	At December 31, 2009	At December 31, 2010
Senior managers excluded from application of the Company's collective bargaining agreements. The terms of their employment are set in personal agreements.	65	63
Permanent employees employed under collective agreements.	3,290	3,073
Employees employed under personal agreements that are not part of the collective agreements.	664	684
Employees employed under individual agreements on the terms of the collective agreement (**"Rank Rating Contracts"**).	26	8
Employees employed in accordance with the special collective agreement of December 2006, on an hourly basis **("Hourly Collective Agreement").**	2,195	2,038
Employees employed under the special collective agreement of December 2006, on a monthly basis **("Monthly Collective Agreement"**).	1,124	1,350
Total	**7,364**	**7,216**

Remark:

The **Hourly Collective Agreement** applies to every "former Generation 2000" worker (see Section 2.17.4D) and former temporary hourly agreement workers, as well as to new workers hired on hourly employment. The **Monthly Collective Agreement** applies to former Generation 2000 workers who were hired in occupations for which employment is monthly in essence, former global salary contract workers, and monthly workers hired in monthly occupation.

For details about the special collective agreement of December 2006 and its amendment in December 2010, see Section 2.9.6.

2.9.3 Early retirement plans

On November 4, 2009 the Board of Directors approved a Company early retirement plan for 2010, in which early retirement was approved for 171 employees[41] (out of 245 employees regarding whom the Company could terminate their employment), at a total cost of approximately NIS 225 million, in accordance with the terms of the special collective agreement of December 2006.

On January 24, 2011 the Board of Directors of the Company approved a Company early retirement plan for 2011 (which includes completion of the quota for 2010), in which up to 260 employees will retire from the Company at a total cost not exceeding NIS 281.5 million, in accordance with the terms of the special collective agreement of December 2006 and its amendment in December 2010. On this matter, see also Note17 to the 2010 Financials and Section 2 of the Directors' Report.

2.9.4 Retirement of permanent employees since January 1, 2011

Between January 1, 2011 and February 28, 2011, 3 permanent employees retired from the Company, in accordance with the early retirement plan.

2.9.5 Company investments in further study, training, employee certification and university studies

The Company conducts in-house training by company employees who are professional experts, at times with outside assistance, in all areas of its operations. Total workdays allocated to training activities for all employees in 2010 was 32,987 days, of which an average of about 4.6 days per employee. The training activities include professional certification in technology, sales, management, service and other areas.

The Company runs a service school that deals with the asimilatio9n of service couture and values at customer service centers and the acquisition of knowledge and skills for providing a superior service. The Company also participates in the financing university studies and courses at outside facilities.

Total Company investment in 2010 in the above activities was approximately NIS 3.6 million, which exceeds the cost of the employees' workdays for training an studies.

2.9.6 The nature of employee agreements in the Company

Labor relations in the Company are regulated in collective agreements between the Company and the representatives of Company employees and the New General federation of Workers ("Histadrut"), and in personal agreements. Company employees are also subject to expansion orders to certain general collective agreements such as cost-of-living increment agreements.

A. Special collective agreement of December 2006

In December 2006, a special collective agreement was signed between the Company and the employees union and the Histadrut, regulating the labor relations in the Company following the transfer of control in the Company from the State to Ap.Sb.Ar. Holdings Ltd, and determining a new organizational structure for the Company (see Section 2.9.1).

Under the agreement, all the agreements, arrangements and traditional behaviors in the Company prior to execution of the agreement, including the mechanism for linkage of wages to the public sector, would continue to apply only to the veteran permanent employees of the Company to which the agreement would apply, subject to changes

[41] In practice, another 12 employees retied from the Company in 2010 in accordance with the early retirement plan (in addition to these 171), at an additional cost of about NIS 11 million.

inserted specifically in the agreement. The hiring of existing and future temporary workers would be on the basis of monthly/hourly wage agreements based on a wage model according to occupation, with high managerial flexibility. The agreement sets out limitations on certain kinds of future organizational changes, and a mechanism of notification, negotiation and arbitration with the union in ht4e event of organizational changes. The agreement also states that the Company can, at its discretion, terminate the employment of 245 permanent employees in each of the years 2009 – 2013.

Under the agreement, during the term of the agreement, two employee-directors will serve on the Board of Directors of the Company, who would be proposed by the union (subject to their election by the general meeting). The employee-directors are not entitled to payment for their service as directors, and will not participate in Board discussions of the terms of employment of senior employees.

B. Amendment of the special collective agreement of December 2006

On December 19, 2010, an amendment to the collective agreement, dating it to December 31, 2015 (with an option for extension top December 31, 2017). The main points of the amendment are these:

1. Extension of the retirement arrangements under the collective agreement to December 31, 2006. Under these retirement arrangements, the Company may, at its discretion, terminate the employment of up to 245 permanent employees in each of the years 2010 – 2016.[42]

2. Definition of "New Permanent Employee", the terms of whose employment differ from those of a veteran permanent employee of the Company (under the collective agreement): his wage model is according to the Company's wage policy and market wages; at the end of his employment in the Company he is entitled to increased severance pay only (depending on the number of years of employment).

3. Agreement of the union to a distribution that does not pass the profit test, of up to NIS 3 billion, with the approval of a court of law pursuant to Section 3093 of the Companies Law and subject to an allotment of options to employees as described below and subject to confirmation from the ratings companies S&P Maalot and Midroog that the rating of the Company's debt after the distribution will not fall below AA and Aa2 respectively (on the matter of the ilAA rating by S&P Maalot on February 6, 2011, see Section 2.13.6). On the matter of the request for approval of a distribution filed in court, see Section 1.4.3.

4. The Company granted to employees, subject to the approval of the general meeting of the shareholders, free of charge, 70,000,000 options exercisable for up to 70,000,000 ordinary shares of NIS 1 par value each (in a mechanism of exercise of stock appreciation rights), accounting for approximately 2.61% of the issued capital of the Company (before the allotment), at an exercise price of NIS 7.457, which will be adjusted for changes in the share capital and for distribution of a dividend. On the matter of allotment of these options, see Section 2.9.7C.

5. The Company will pay its employees a one-t0me bonus for performance in 2010, amounting to approximately NIS 52 million, which will be paid in two equal installments in the January 2011 and January 2012 wages.

For details of other material agreements concerning labor relations, see Section 2.17.4.

2.9.7 <u>Employee reward plans</u>

A. 2007 stock options plan

The Company's employee stock options plan (which excludes senior management), in which 78,151,368 options were allotted free of charge on March 25, 2007,[43] based on criteria laid down in the collective agreement December 5, 2006, exercisable for 78,11,368 shares of the Company, which accounted for about 3% of the Company's

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[42] The Company may complete the retirement process also in 2017, if it is not completed in the above year.

[43] Of which approximately 59,000 options were allotted to two employee-directors on January 22, 2008.

capital, at an exercise price (adjusted for all types of distribution and the like[44]) of 50% of the last closing price of the share prior to the date of allotment (NIS 3.201 per share).

The options were blocked for two years from the date of allotment, and can be exercised during the three years from the end of the blocking period (at March 1, 2011, 63,093,609 options from this plan had been exercised).

For additional details about the terms of the stock options plan, see the Company's Outline Offering of Securities published by the Company on February 22, 2007, which is cited by way of reference.

B. Stock options plan for senior managers in the Group, November 2007

A stock options plan for managers and senior employees in the Company and/or in related companies for the allotment of up to 65,000,000 non-marketable options, exercisable for up 60 65,000,000 shares of the Company, accounting for approximately 2.5% of the Company's issued share capital and approximately 2.37% at full dilution. The plan includes a mechanism for exercise of stock appreciation rights, so that the exerciser receives a number of shares reflecting the value of the benefit only, without actually paying an exercise price.

The options will vest in three equal annual portions. The vesting dates of each portion fall at the end of each of the first, second and third years from the date of grant, respectively.

The exercise price of each option will be NIS 5.50, and reflected a discount of about 16.8% on the closing price of the Company's shares on the Tel Aviv Stock Exchange on January 31, 2008, the date of approval by the general meeting. In accordance with the resolution of the Company's Board of Directors on June 26, 2008, the exercise price of each option allotted from that date onwards is equal to the average closing price of the Company's shares in the thirty days prior to the date of the Board's decision to allot the options.[45]

At March 1, 2011, 59,050,001 options exercisable for up to 59,050,001 shares had been offered in accordance with this stock options plan (net of options that had expired), including to the CEO of the Company and a former Chairman of the Board.

For more information about the stock options plan, see the Outline Offering to Employees and material private placement published by the Company on December 25, 2007, and the Outline Offering to Employees published by the Company on March 3, 2008, May 27, 2009 and March 3, 2010, which are cited by way of reference.

C. Employee stock options plan – 2010

On December 19, 2010, the Board of Directors of the Company approved an employee stock options plan (including to two employee-directors and excluding senior management), I which 70,000,000 options will be allotted, free of charge and exercisable for 70,000,000 ordinary shares of NIS 1 par value each (in a mechanism for exercise of stock appreciation rights), accounting for approximately 2.61% of the issued capital of the Company (before the allotment), at an exercise price of NIS 7.457, which will be adjusted for changes in the share capital and for distribution of dividends. The options will vest in three equal annual portions.[46] The vesting dates of each portion will fall at the end of each of the first, second and third years from the

[44] In view of the expected fall in the exercise price of the options to below the par value of the share (NIS 1) as a result of adjustment of the exercise price for the distribution of a dividend, on March 18, 2010 the Board of Directors of the Company approved that the Company would convert to share capital, out of a premium on shares registered in the Company's books, a sum equal to the difference between the par value of the share and the exercise price of the options exercised under this plan, in a total not exceeding NIS 22,469,081. Conversion of the premium to share capital would be registered in the Company's books against the actual exercise of options at the time of exercise.

[45] Excluding the allotment to the CEO of an investee company on September 25. 2008, on the original terms (exercise price of NIS 5.3 and adjusted for distributions of dividends).

[46] Except for a person who was a permanent employee of the Company on April 14, 2010 and took early retirement prior to the first allotment date under the plan, for which all the options will vest immediately upon their allotment, and excluding a permanent employee who signs a retirement agreement and ends his employment in the Company, for whim the vesting period for unvested options will be expedited so that they will vest on the date of retirement of the permanent employee.

date of grant, respectively. The options will be exercisable commencing from the end of their blocking period (two years) and until the elapse of 5 years from the date of grant (and in any case, no later than the date on which the plan expires – December 31, 2018). The stock options plan was adopted following the Company's undertaking pursuant to the December 2010 amendment of the 2006 collective agreement (see Section 2.9.6). Allotment of the options (and the shares underlying them)was approved by the general meeting of the shareholders on January 11, 2011. At March 1, 2011, 67,552,269 options had been allotted, which are exercisable for 67,552,269 shares.

For more information about this plan, see the Outline Offering of Securities to Employees published by the Company on December 20, 2010 and on March 7, 2011, which are cited by way of reference.

D. "Phantom" stock options plan for senior employees (2010)

On December 30, 2010, the Board of Directors of the Company adopted a "phantom" stock options plan under which 16,400,000 "phantom" options will be granted to senior managers in the Company and in the subsidiaries Pelephone and Bezeq International, which will be exercisable for a monetary bonus (and not for Company securities)in a sum equal to the difference between the average price per shares in the 30 days prior to the date of grant (subject to adjustments)and the closing price of the shares on the trading day before the date of the notice of exercise. The options will vest in three equal annual portions. The vesting dates of each portion will fall at the end of each of the first, second and third years from the date of grant, respectively. The options can be exercised commencing from the end of the vesting period of each portion, until the elapse of give years from the date of grant. All the options under this plan were allotted on January 1, 2011.

For more information about this plan, see the immediate report of the Company dated December 30, 2010, which is cited by way of reference.

On the matter of this Section 2.9.7, see also Note 27 to the 2010 Financials.

2.9.8 Officers and senior management in the Company

On the date of publication of this Periodic Report, the Company has 14 directors, of whom two are external directors, two are employee-directors (see Section 2.17.3F) and two are "independent" directors pursuant to Section 249B of the Companies Law. In addition, senior management has 14 members.

The Chairman of the Board of the Company through the end of 2010 was a salaried employee.[47] The terms of his employment were described in an immediate report issued by the Company on April 18, 2008, concerning a private placement and terms of employment of the Chairman, which is cited by way of reference. Commencing January 1, 2011, Mr. Shaul Elovitz, the controlling shareholder (indirectly) in the Company serves as Chairman of the Board of Directors of the Company.

The two external directors and the two independent directors serving on the Board of Directors receive compensation in accordance with the Companies (Rules for compensation and expenses of an external director) Regulations, 2000. The other directors do not receive any compensation or other pay from the Company in respect of their service as directors he two employee-directors receive a salary for their work in the Company and not for their service as directors).

The members of the senior management are employed under personal agreements which include, inter alia, pension coverage, payment of bonuses based on targets, and advance notice months before retirement. The Company also allots options for Company shares to the members of senior management, at its discretion (see Section 2.9.7).

[47] Until June 2, 2011, the previous Chairman of the Board is in his notice period (see Section 7A in Chapter D of the Periodic Report.

2.10 Equipment and suppliers

2.10.1 Equipment

The principal equipment used by the Company is exchanges, copper cables, optical cables, transmission equipment, data communication systems and equipment, servers, Internet modems and routers. The Company purchases most of the equipment needed for its communications infrastructure from Israeli companies affiliated with international communications equipment manufacturers. Hardware and software are purchased from a number of suppliers.

2.10.2 Percentage of purchases from principal suppliers and form of agreement with them

During 2010, the Company had no suppliers from which the volume of purchases exceeded 5% of the Group's total annual purchasing, or suppliers from which the volume of purchases exceeded 10% of total purchasing in a particular segment of operation.

2.10.3 Dependence on suppliers

Most of the equipment purchased for data communication, switching, transmission and radio systems is unique, and over its years of operation the possibility of obtaining support other than through the manufacturer, is limited.

In the opinion of the Company, in view of the importance of manufacturer support for certain systems used by the Company, it could become dependent, in the areas of public switching and metro transmission, on Alcatel Group, represented in Israel by Alcatel Telecom Israel Ltd., which supplies the Company with transfer exchanges for linking operators to the switching network in the Company and transmission network equipment, while in public switching the Company is also dependent on Varez Networks, which also supplies the Company with transfer exchanges for linking operators to the switching network in the Company. In public switching equipment, the Company could also become dependent on Comverse, which supplies the Company with switching exchanges to end users in the NGN, in billing systems on Amdocs Software Systems, in databases and CRM systems on Oracle, and in transmission – on ECI, which supplies the Company with systems for the transmission system for connecting the Company's network to business customers.

2.11 Working capital

Inventory purchased by the Company is for the most part intended for investment in property, plant and equipment. The Company’s inventory policy strives to maintain an inventory sufficient for the Company’s needs for average consumption as determined from time to time, with flexibility in exceptional cases, depending on the nature of the consumption and price of the item. Orders from suppliers are made taking into consideration past demand and projections for the future.

At December 31, 2010, the deficit in the Company's working capital was NIS 1,208 million (this figure relates to the separate financial statements of the Company. The working capital deficit in the 2010 financials was NIS 93 million). The Board of Directors of the Company determined on March 7, 2011 that despite the deficit, liquidity is not a problem for the Company. See Section 4 of the Directors' Report.

The following table shows data on supplier and customer credit in 2010:

	Average credit extended (NIS millions)	Average credit days
Customers*	896	54
Suppliers	263	37

* After elimination of doubtful debts.

2.12 Investments

For information on investments in affiliates, see Note 13 to the 2010 Financials, and see also Sections 3 and 4 in Chapter D of this Periodic Report.

2.13 Financing

2.13.1 Average and effective interest rates on loans

At 31 December 2010, the Company is not financed by any short-term credit (less than one year). The table shows the distribution of the long-term loans (including current maturities):

Source of financing	Amount at Dec. 31, 2010	Currency or linkage	Type of interest and change mechanism	Average interest rate	Effective interest rate	Interest range in 2010
Banks	1,300	Unlinked NIS	Variable, based on prime rate*	3.77%	3.80%	2.77-3.27%
Banks	1,300	Unlinked NIS	Fixed	5.35%	5.42%	-
Non-bank	2,215	CPI-linked NIS	Fixed	4.09%	4.09%	-

2.13.2 * Prime interest rate in March 2011 – 4%.

2.13.2 Limitations on borrowings

A. Limitations included in the Company's loans

See Note 14 to the 2010 Financials. At the date of the financial statements and the date of publication of this Periodic Report, subject to the contents of the above Note, the Company is in compliance with all the limitations applicable to it.

B. Bank of Israel restrictions on a single borrower and group of borrowers

Directives of the Supervisor of Banks include restrictions on liability of a single borrower and of a group of borrowers towards the banks. Concerning these directives, the Company could be seen as part of one "group of borrowers" with B Communications Group and its controlling shareholders. The directives of the Supervisor of Banks could from time to time affect the ability of banks to grant further credit to the Company.

2.13.3 Credit received during the reporting period

On April 15, 2010, the Company completed the raising of NIS 1.5 billion of debt by means of loans from Israeli banks at an average duration of 4.5 years (at the date of the loan).

On May 6, 2010, the Company completed a recycling of bank loans received on March 12, 2009 in a total amount of NIS 400 million, by means of loans from Israeli banks at an average duration of 4.6 years (at the date of the loan).

On September 1, 2010, the Company completed the raising of NIS 700 million of debt by means of loans from Israeli banks at an average duration of 4.78 years 9at the date of the loan).

On this matter, see Note 14 to the 2010 Financials.

2.13.4 Credit received during the reporting period

The Company has taken no loans after December 31, 2010. For details about a letter of undertaking to make a credit facility available, see Section 2.13.7.

2.13.5 Company debentures

The Company issued two series of debentures (series 4 and 5), which were listed for trading on the Stock Exchange. For details of the terms of the debentures and of debentures held by a subsidiary of the Company, see Section E in the Directors' Report and Section 2.17.1 below. The Company also issued debentures in a private placement which were not listed for trading on the Stock Exchange, the balance of which in the Company's books at December 31, 2010, was approximately NIS 102 million.

2.13.6 Credit rating

The Company is rated by two rating agencies.[48] Below are details of the rating of each of the agencies at the date of publication of this Periodic Report (including the latest updates):

Rating agency	Rating	Changes in rating	Type of credit rated
S&P Maalot	ilAA +	May 27, 2010 – Ratification of the Company's rating of ilAA+ (removal from CreditWatch with negative outlook due to notice of sale of core control in the Company). The outlook in this notice was stable. December 22, 2010 – Transfer to CreditWatch with negative outlook due to the Company's notice on December 19, 20109 stating that it is considering a capital reduction of NIS 3 billion by way of a special dividend and/or buy-back. February 11, 2100 - Ratification of the Company's present rating of ilAA+ (removal from CreditWatch as above). The outlook is negative.	The Company and Debentures Series 4 and 5
Midroog	Aa1	December 6, 2010 – Re-approval of Aa1 rating with stable outlook. January 2, 2011 – Transfer to Watch List with negative outlook, following the Company's notice of distribution of a dividend of NIS 3 billion in 2011-2013, which does not pass the profit test.	Debenture series 4 and 5

2.13.7 Company assessment for raising financing and possible sources in 2011

During 2011, the Company expects to repay approximately NIS 940 million on account of loan principals and interest (including debentures). For details of expected repayments by Pelephone in 2011, see Section 3.15.6.

The Company intends to raise debt during 2011 for the repayment of loans as described above, and for its current need, including for financing a distribution that does not pass the profit test (see Section 1.4.3). Raising such funds will increase the Company's leverage and its financing expenses. At the date of this report, no decision has been made concerning the amount of financing that will actually be raised.

On February 17, 2011 the Company received a letter of undertaking from an Israeli bank to provide a long-term credit facility of up to NIS 1.5 billion for financing the Company's cash flow needs. The facility can be used for a period of one year, subject to terms agreed by the parties.

The Company is preparing to file a first draft of a shelf prospectus o the Securities Authority in March 2011. At the date of this report, no decision has been made on raising funds under the prospectus, if it is published,

The Company's financing options are to raise debt by means of new bank loans and/or by means of raising debt or capital on the capital market, and to raise debt by selling debentures from series 5, which are held by Bezeq Zahav Holdings, a wholly-owned subsidiary.

2.13.8 Charges and guarantees

For information about charges and guarantees of the Company, see Note 14 and 20 to the 2010 Financials.

2.14 Taxation

For information on the subject of taxation, see Note 9 to the 2010 Financials.

[48] In addition, the Company was rated internationally in the past (until December 2010) by Standard & Poor's (BBB+) and by Moody's (Baa1). Sine this rating is no longer needed, it has been cancelled.

2.15 Environmental risks and their management

2.15.1 General

Some of the Company's facilities, such as broadcasting facilities and wireless communications facilities, are sources of electromagnetic radiation which are included in the definition of "Sources of Radiation" in the Non-Ionizing Radiation Law.

2.15.2 Non-Ionizing Radiation Law

The law regulates the handling of Sources of Radiation, their erection, operation and supervision. The law provides, inter alia, that the erection and operation of a Source of Radiation and the provision of a radiation measurement service require a permit; sets penal provisions and severe strict liability of a company, employees and officers; imposes recording and reporting obligations on a permit-holder, and grants supervisory powers mainly to the Supervisor of Non-ionizing Radiation at the Ministry for Protection of the Environment (**"the Supervisor"**), including for the matter of the terms of the permit, cancellation of the permit and removal of a Source of Radiation.

The Company obtained operating permits from the Supervisor for the communication facilities and broadcasting sites it operates.

It is noted that the Commissioner may require building permits as a condition for the continued validity of the operating permits for communications facilities (including broadcasting facilities) he granted, as well as the fulfillment of additional conditions, inter alia, concerning wireless access installations which have category approval granted to the Company by the Supervisor. See also Section 2.16.11.

Regulations concerning non-ionizing radiation criminal liability for the matter of failure to take and report measurements in accordance with the provisions of the regulations.

2.15.3 Permits

On the permits for broadcasting facilities required under the Planning and Construction Law, see Section 2.16.11.

2.15.4 Claims

On claims in the matter of ostensible radiation from the Hillel broadcasting station, see Section 2.18.3. It is noted that the Company's third party liability insurance does not currently cover damages in respect of electromagnetic radiation.

2.15.5 Company policy for radiation risk management

The Company applies a work procedure for the erection, operation and measurement of sources of non-ionizing radiation, and an appropriate compliance procedure that was approved by its Board of Directors. The Company has assigned an officer to oversee implementation of the compliance procedure. Periodic reports on the status of Sources of Radiation are submitted to the CEO and to the Board of Directors.

2.16 Restrictions and control of the Company's operations

The Company is subject to systems of laws that regulate and limit its business activities. The principal body overseeing the Company's activities as a communications company, is the Ministry of Communications.

2.16.1 Control of Company tariffs

Arrangements in Sections 15 to 17 of the Communications Law and the terms of the Company's license, apply to the Company's tariffs.

A. Tariffs fixed in the regulations - The tariffs for the Company’s controlled services (telephony and others) which are fixed in regulations promulgated by virtue of the aforementioned Section 15, were updated in accordance with a linkage formula less an efficiency factor consisting of linkage to the CPI plus an efficiency factor), as provided in the regulations, so that on average, the Company's controlled tariffs erode in real terms.

The Competition Policy Documents (see Section 1.7.3) state that as long as the Group's market share is higher than 60%, tariff control will continue in a format of fixing binding tariffs. The recommendations of the Hayek Commission for reviewing and revising the structure of the Company's tariffs, if adopted, could change the mechanism for fixing and updating the tariffs. On the Hail Committee's request for positions on its recommendations published on March 3, 2011, see Section 1.7.3.

B. Alternative payment packages – Under Section 15A of the Communications Law, if tariffs are fixed for the services controlled under the aforementioned Section 15, the Minister may, with the consent of the Minister of Finance, approve the request made by the licensee for an alternative payment package for a service package. The approval mechanism was simplified in December 2010 as part of the Arrangements Law, so that the Company can offer an alternative payment package after the period defined in the law unless the Minister of Communications or the Minister of Finance announces his objection. The Competition Policy Documents (see Section 1.7.3) state that an alternative payment package will be approved only of it is worthwhile for 30% or more of consumers subscribers who consume the services offered in the package, and the smaller the market share of the Group in fixed-line telephony, the higher the maximum discount rate permitted in an alternative payment package can be.[49]

C. Duty to set reasonable tariffs for services – Under Section 17 of the Communications Law, "a license-holder can demand reasonable payment for a telecommunications service for which payment is not fixed in Section 15." For these of its services, the Company sets the tariffs.

The control of the Company's tariffs has a number of implications: once every few years, the Company's controlled tariffs are reviewed by a public committee, and the Company is exposed to material changes in its tariff structure and tariff levels. The review mechanism for the controlled tariffs, as defined in the regulations, results in a real average erosion of the tariffs over the years. Control of the tariffs creates or could create difficulties for the Company in providing a appropriate and competitive response to changes in the market and in offers of competitive prices at short notice. Furthermore, the restrictions on granting discounts on tariffs limit the Company in participation in certain tenders.

2.16.2 The Company's Domestic Carrier license

The Company operates, inter alia, under the Domestic Carrier license.[50] The main topics covered in the license are these:

A. Scope of license, the services the Company must provide, and the duty of universal service

To provide its services to all on equal term for each type of service, irrespective of the location or unique cost. The license is unlimited in time; the Minister may modify or cancel the license or make it contingent; the license and any part of it cannot be transferred, no charge can be imposed on it, nor can it be subject to attachment.

B. Principles of structural separation

For a general description of the structural separation applicable to the Company, see Section 1.7.2. The Company employs various means or compliance with these principles among its employees, including training sessions and periodic refresher courses on the relevant procedures.

In 2009, the Ministry of Communications notified the Company that it was considering imposing a monetary sanction on the Company in the amount of NIS 15,000,000, in respect of alleged violation of the provisions of the license relating to structural separation, due to the ostensible transfer of commercial information about Company customers to subsidiaries. Soon after the date of the notice, the Company submitted

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[49] A maximum discount rate of 25% when the Group's market share in between 75% and 85%, and 40% when the market share is between 60 and75%.

[50] A copy of the Domestic Carrier license appears on the Ministry of Communications website at www.moc.gov.il.

its detailed response to the notice, stati8ng that it has not violated the provisions of the license and the imposition of a monetary sanction was unjustified.

C. Marketing joint service bundles

On amendment of the Domestic Carrier license in a way that enables the Company to request to market joint service bundles subject to limitations, and a draft amendment to the licenses of the Group concerning the marketing of joint bundles to the business sector, see Section 1.7.2.

D. Tariffs

The Company provides a service or package of services for which no tariff is set under Section 15 of the Communications Law, at a reasonable price and offers them to all, without discrimination and at a uniform tariff. See also Section 2.16.1.

E. Operations of Company networks and service standards

The Company is required to maintain and operate the network and provide its services at all times, including at times of emergency, in an orderly and proper manner commensurate with the technical requirements and the nature of the service, and to work towards improving its services. The license includes an appendix, “Service Standards for the Subscriber”, which is to be amended after the Company provides the Ministry with data. The Company submitted to the Ministry its proposal for amendment of the appendix, adapting it to the current state of affairs and the licenses of other operators, but the amendment has not yet been made.

F. Interconnect and use

Provisions are stated for the duty of interconnect to another public switching network and the option of use by another license-holder; a duty to provide infrastructure services to another license-holder on reasonable and equal terms is also provided, as well as refraining from preferring a license-holder that is a company with an interest.

G. Security arrangements

Provisions have been made for operation of the Company's network in times of emergency. The Company is required to set up and operate its network in a way that prevents its collapse in an emergency and enables a reduction of activity in certain sectors.

The Company is required to provide telecommunications services and set up and maintain the terminal equipment infrastructure for the security forces in Israel and abroad, as provided in its agreements with the security forces. Furthermore, the Company provides special services to the security forces. The Company will take action to ensure that each purchase and installation of hardware in its telecommunications installations, except for terminal equipment, will be made in full compliance with instructions given to the Company according to Section 13 of the Communications Law, the amendment of which was split off from the Arrangements Bill, the main point of which was the imposition of financing certain operations according to the requirements of the security forces on the license holder. The Company submitted is position, which opposes the proposed amendment, to the Knesset Foreign Affairs and Security Committee.

The Company is required to appoint a security officer and to comply fully with the security instructions contained in the appendix to the license.

H. Supervision and reporting

Extensive reporting duties are imposed on the Company, such as filing the reports specified in the license and information and reports on-demand on various matters. In addition, the Director General at the Ministry of Communications is granted the authority to enter facilities and offices used by the Company and to seize documents.

I. Miscellaneous

1. The Domestic Carrier license includes limitations on the acquisition, maintaining and transfer of means of control pursuant to the Communications Order (see Section 2.16.3), as well as on cross-ownership, which are mainly a ban on cross-

holding by entities in which those with an interest in a another material Domestic Carrier[51] as noted in the license, and limitations on a cross-holding by entities with Domestic Carrier licenses or general licenses in the same segment of operation.

2. The Company is required to prepare the text of the agreement it plans to offer to subscribers, and to submit it to the Director General upon his demand. The Director General has the authority to instruct that changes be made. The Company is in an ongoing process of preparing such an agreement.

3. The Company is required to submit to the Director General a bank guarantee for securing fulfillment of the terms of the license and for indemnifying the State for any loss it incurs due to their violation, in a sum equal to USD 10 million. The Company provided such a guarantee. The Minister may render the guarantee or part of it forfeit on terms set out in the license.

4. The Director General at the Ministry of Communications is competent to impose a monetary sanction for violation of any of the terms o the license.

5. During a calendar year, the Company may invest up to 25% of its annual income in activities not intended for providing its services (the incomes of the subsidiaries are not considered Company income for this purpose). The Minister of Communications is competent to permit deviation from that percentage.

On the Hayek Commission's request for positions on its recommendations published March 3, 2011, see Section 1.7.3.

2.16.3 <u>The Communications Order</u>

The Company was declared a provider of telecommunications services under the Communications Order. By virtue of that declaration, the Company is required to provide certain types of services and may not interrupt them or narrow them. Among these services are basic telephone service, infrastructure service, transmission service and data communication service including interconnect, and other services listed in the schedule to the Order.

The main provisions of the Communications Order are these:

a. Limitations on the transfer and acquisition of means of control in a company, which includes a ban on holding 5% or more of means of control of a certain kind without the prior written approval of the Prime Minister and the Minister of Communications (**"the Ministers"**).

b. Transfer or acquisition of control in a company requires the approval of the Ministers (**"Control Permit"**). The Control Permit will lay down the minimum holding percentage in each of the means of control in the company by the holder of the Control Permit,[52] where a transfer of shares or an issuance of shares by a company, as a result of which the percentage of the holding of the Control Permit holder will fall below the minimum percentage, is prohibited without the prior approval of the Ministers, subject to permitted exceptions (among them – an issuance to the public under a prospectus, or sale or private placement to institutional investors).

c. Holdings not approved as aforesaid will be considered "exceptional holdings", and the Order states that exercise of a right by virtue of exceptional holdings will not be valid. The Order also contains provisions authorizing the Ministers and the company to apply to the courts with an application for the enforced sale of exceptional holdings.

d. A duty to report to the Ministers upon demand is imposed on the Company, on any information on matters relating to provision of an essential service.

e. 75% of the members of the Board of Directors in the Company must be Israeli citizens and residents who have security clearance and security compatibility as determined by the General Security Service. The Chairman of the Board, the external directors,

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[51] A Domestic Carrier with a market share of 25% or more.

[52] As noted in Section 1.3.1, at the date of publication of this Periodic Report the minimum rate of holding in the Control Permit of B Communications Group is 30%. For the matter of a tome-restricted approval for falling below the Minimum Percentage to 29% due to exercise of options, see Footnote 11.

the CEO, the Deputy CEO and other office-holders in the Company as listed in the Order, must be Israeli citizens and residents and have security clearance appropriate to their functions.

f. "Israeliness" requirements are laid down for the controlling shareholder in the Company: for an individual – he is an Israeli Entity (as defined in the Order); for a corporation – it is incorporated in Israel, the center of its business is in Israel, and an Israeli Entity holds at least 19% of the means of control in it.

g. The approval of the Ministers is required for granting rights in certain assets of the Company (switches, cable network, transmission network and data bases and banks). In addition, grant of rights in means of control in subsidiaries of the Company, including allotment of more than 25% of the shares in the subsidiary, requires the approval of the Ministers.

h. Provisions are laid down for the matter of protection of computerized systems and the purchasing of hardware and software.

i. Certain actions of the Company require the approval of the Minister of Communications, among them voluntary liquidation, a settlement or arrangement between the Company and its creditors, a change or reorganization of the structure of the Company, a merger and split of the Company.

2.16.4 Royalties

For details about the duty to pay royalties applicable to license-holders pursuant to the Communications Law and about the rise in the percentage of royalties applicable to the Company, see Section1.7.3B.

The Company's royalties expense in respect of 2010 is approximately NIS 32.2 million, compared with NIS 49.3 million in 2009 (these amounts do not include adjustments in respect of prior years). The royalties rate for 2010 was 1% of taxable income (as defined in the regulations), compared with 1.5% in 2009.

It is noted that the Company opposes the raising og the royalties rate, which reflects, in the Company's opinion, a violation of a government promise, an unjustified change in policy, and gross discrimination against a general Domestic Carrier.

2.16.5 Authority with respect to real estate

Pursuant to the provisions of Section 4(F) of the Communications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law.

The law distinguishes between land owned by the State, the Development Authority, the Jewish National Fund, a local authority or a corporation lawfully established and owned by one of them, and a road (**"Public Land"**), and other land (**"Private Land"**). With regard to Public Land, the Company and any person authorized by it, can enter and perform work there, provided that approval for deployment of the network has been granted by the local Planning and Construction Committee in the manner prescribed in the law. In most cases, the occupier must be given 21 days' notice and the latter may appeal to the Court.

Under the provisions of the Telecommunications (Installation, operation and maintenance) Regulations, 1985, if the Company is of the opinion that providing a telecommunications service to an applicant requires the installation of a telecommunications device for transmission or switching on the applicant's premises (or in shared premises or common property), the Company is permitted to request that the applicant, as a prerequisite for providing the requested service, allocate a suitable place on the premises for installation of the device, for the sole use of the Company, and it may use the device to provide service to other applicants also.

Deployment of a network on Private Land requires the consent of the landowner, the lessee in perpetuity or the protected tenant, as the case may be. In a condominium, the consent of a majority of the apartment owners is required. Nevertheless, the law contains provisions concerning deployment of a network in a condominium at the request of an apartment-owner, even in the absence of the consent of the majority of the apartment-owners, and grants authority to the "house committee" and the Supervisor of Condominiums.

In September 2010 the Planning and Construction (Application for a permit and its terms and fees) Regulations, 2010, came into force, which impose on the applicant for a permit to erect a residential building, a duty to install infrastructures for telephone, radio, television and Internet services so that the customer can choose whichever provider it prefers. In commercial buildings, if preparations for communications are installed, an underground infrastructure must be laid. At the same time, the Company's license was amended (as were the licenses of HOT Telecom and DBS) so that if the Company uses the internal wiring for providing its services, it is obliged to provide maintenance services for that wiring in apartments where it was requested by the permit applicant, without this granting it any proprietary rights in the internal wiring.

2.16.6 Immunities and exceptions to liability

The Minister of Communications granted the Company certain immunities from liability for from damages listed in Chapter Nine of the Communications Law, in accordance with his authority to grant immunity to a general license-holder.

In addition, Section 13 of the law contains exceptions to criminal and civil liability for an act done in fulfillment of a directive to provide services to the security forces in that section.

2.16.7 Regulations and rules under the Communications Law

At the date of publication of this Periodic Report, regulations in three additional and important areas apply to the Company: (1) interruption, delay or limitation of telecommunications actions and services; (2) installation, operation and maintenance; (3) ways of overseeing the actions of the license-holder. In addition to these, the Company, with the approval of the Minister, has set rules for the matter of its services to subscribers.

2.16.8 Antitrust laws

A. On July 30, 1995, On June 27, 1995, the Antitrust Commissioner (in this section – **"the Commissioner"**) declared the Company a monopoly in the following areas:

1. Basic telephone services, provision of communications infrastructure services, and transfer and transmission of broadcasting services to the public.[53]
2. Provision of high-speed access services through the access network to the subscriber.[54]
3. Provision of high-speed access services for ISPs through a central public telecommunications network.

The Commissioner's declaration of the Company as a monopoly constitutes prima facie evidence of its content in any legal proceeding, including criminal proceedings. Accordingly, a plaintiff – a person or consumer organization – seeking to sue the Company, whether in a personal civil action or in a class action, is excused from proving the fact that the Company is a monopoly, to the extent this proof is relevant its claim, in reliance on the Commissioner's declaration, and the Company will bear the burden of proof of refuting the Commissioner's declaration in this regard.

B. The Company has adopted an internal compliance procedure containing internal rules. guidelines and an internal reporting and control array, the purpose of which is to ensure that the activities of the Company and its employees are carried out in accordance with the provisions of the Antitrust Law.

C. In its decision on August 20, 209, the Supreme Court allowed the appeal of the Antitrust Commissioner against the decision of the Antitrust Tribunal in February that year, which allowed the merger of the Company with DBS, and decided not to allow the merger, See Section 1.1.2.

D. On March 31, 2010, a merger of B Communications and the Company was approved, following the acquisition of core control in the Company by B Communications as described in Section 1.3.1.

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53 Declaration on July 30, 1995.

54 On November 10, 2004, the Commissioner split the declaration of December 11, 2000 on Internet access infrastructure into two separate declarations (Declarations 2 and 3).

E. As part of the approval of the merger of the Company and Pelephone on August 26, 2004, restrictive terms were imposed, mainly prohibiting discrimination in favor of Pelephone in the supply of a product in which the Company is a monopoly, prohibiting the bundling of the supply of certain products by either of the companies when purchasing products or services from the other, and limitations on certain joint activities. On October 10, 2010, these terms were amended, removing some of those relating to joint marketing.

F. On September 12, 2010, the merger of Walla and the Company was approved following the Company's acquisition of Walla shares (see Section 1.1.2), on terms that restrict discrimination in favor of Walla vis-à-vis its competitors.

G. During the Antitrust Authority's 2010 examination of the Company's conduct in the matter of providing its transmission services for use by competing Domestic Carrier licensees (see Section 2.6.3), the Company submitted to the Authority a detailed position paper showing that the Company is not required to provide the transmission services to competitors and data as requested by the Authority.

2.16.9 The Telegraph Ordinance

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

The Government deals with the shortage of radio frequencies for public use in Israel (among other reasons, due to the allocation of a large number of frequencies for security purposes), by limiting the number of licenses granted for the use of frequencies on the one hand, and increasing the fees payable for allocation of frequencies, on the other. The Company and the Ministry of Communications have a number of differences of opinion concerning fees which the Company contends it is not required to pay and therefore has not paid them. Following a clarification with the Ministry regarding these disputes, most have been settled. The main sum remaining in dispute relates to fees in the Administered Territories, and at December 31, 2010 amounted to approximately NIS 72 million.

On September 1, 2010, the State authorities filed a claim in this matter in the Jerusalem District Court. See Section 2.18.9.

2.16.10 Consumer legislation

Frequent changes in consumer legislation regularly affect the activities of the Company.

In its activities, the Company is subject to the Consumer Protection Law. In March 2010, an amendment to this law came into force, enabling a consumer to cancel a remote sale transaction even after the start of providing the service. The amendment broadens the rights of cancellation in case of deception. In December 2010, regulations came into force which allows cancellation of a transaction and a refund also in cases which are not remote sale transactions. These amendments are added to others made to the Consumer Protection Law in the past two years, inter alia in the matter of options for disconnecting from ongoing services and the need for specific consent to continue transactions after the end of the defined period.

2.16.11 Setting up communications facilities

A. General

The National Outline Plan for communications, NOP 36 (within the Green Line) and NOP 56 (in the Administered Territories), were designed to regulate the deployment and manner of set-up of communications facilities in a way that would ensure coverage for transmitting and receiving radio, television and wireless communications, while avoiding radiation hazards and minimizing the damage to the environment and the landscape, and also to simplify and increase the efficiency of the processes involved in setting up the facilities.

The classification of the facilities according to their technical variables and physical dimensions, which affect the determination of safety ranges for protection against the effects of radiation and the extent to which they protrude on the landscape, determine which facilities will be included in Part A of the Plan and which in Part B of the Plan.

The Company has erected and is erecting broadcasting facilities wireless communication facilities, mainly for providing services to area which are not connected to the fixed-line communications infrastructure (remote areas or new towns), and for providing the broadcasting services for the Company's customers.

B. NOP 36A

1. Part A of NOP 36 deals with guidelines for erecting small and miniature broadcasting installations.

2. The Company has obtained building permits for most of the small broadcasting installations in accordance with NOP 36A. From time to time, a need arises to add broadcasting installations which require that building permits be obtained in accordance with NOP 36A.

3. Given the exemption granted it under the provisions of the Planning and Construction Law and of the Communications Law, the Company believes that it is not obliged to obtain building permits for miniature broadcasting installations, which are “wireless access facilities” under those laws.

   There are a number of initiatives to cancel this exemption, and its cancellation could have materially adverse implications, including difficulty in providing universal service as required by the provisions of the Company's license, and which the Company is unable to assess at this stage.

   For possible implications of cancellation of the exemption for Pelephone – see Section 3.18.4.

4. In January 2008, the Planning Administration issued a draft amendment to NOP 36A (NOP 36/A/1), with the aim of changing the guidelines for the licensing of small and miniature broadcasting installations. The draft cancels the definition of a miniature broadcasting installation and changes the definition of a small broadcasting installation. In addition, different licensing tracks are defined (fast and standard), depending on the location and the public safety range of each installation. In these tracks, indemnification arrangements (of differing amounts) are set for claims for compensation under Section 197 of the Planning and Construction Law.

   The change of definition of small broadcasting installations and large broadcasting installations, presents practical difficulties which could impede the Company's ability to provide the public with some of the services it is required by law to provide.

   NOP 36/A/1 has not yet been approved by the government, and there is no certainty as to the final text that will be approved. If changes are made in the final text compared with the present draft, they could materially affect the Company.

C. NOP 36B

Part B of NOP 36 contains guidelines for setting up large broadcasting facilities. In the January 2008 draft plan (which was presented to the government for approval in August 2010), the definition of a large broadcasting facility was changed so that the licensing of broadcasting facilities which prior to the proposed amendment were classified as large, would be according to NOP 36/A/1 (if and when approved), which does not include transition provisions for an abridged licensing proceeding. The change in definition for small and large broadcasting facilities presents practical difficulties which could impede the Company's ability to provide the public with the services it is required by law to provide.

The January 2008 draft contains a transition provision which is expected to allow grant of a license for existing broadcasting installations even if they do not meet the requirements of NOP 36B, subject to certain terms and restrictions, provided that they are in compliance with the safety restrictions described in the Plan. The January 2008 draft also proposes to include a provision requiring the license applicant (including for existing sites) to provide the local committee with a deed of indemnity for compensation under Section 197 of the Planning and Construction Law, if a court rules against the committee.

NOP 36B has not yet been approved by the government, and there is no certainty as to the final text that will be approved. If changes are made in the final text compared with the present draft, they could materially affect the Company.

D. On radiation permits for communications and broadcasting facilities, see Section 2.15.

E. NOP 56 – Communications facilities in the Administered Territories

NOP 56 came into force in June 2008, and regulates the manner of erection and licensing of communications facilities in the Administered Territories. The Plan contains transition provisions for facilities erected with a permit for small installations.

The Plan also includes a requirement for production of a communications license and receipt of the consent of the Commissioner of Government Property at the Civil Administration.

The Company has started the licensing process for installations and has deposited 42 files for existing installations that meet the terms of the transition period, and is attending to the licensing of another 41 installations in the Administered Territories.

2.17 Substantial agreements

Below is a brief description of substantial agreement outside the normal course of the Company's business, which were signed in the reporting period and/or which are in force.

2.17.1 <u>Agreements concerning debentures</u>

A. Deed of trust for Debentures (Series 4), dated May 24, 2004

A deed of trust signed with the Mizrachi Bank Trust Company Ltd. for a series of 1,200,000,000 debentures of NIS 1 par value each, repayable in four equal annual installments on June 1 of each of the years 2008 to 2011, at 4.8% annual interest, linked (principal and interest) to the CPI for April 2004. Of these, 800,000,000 debentures were issued to the public under the Company's prospectus (**"the Prospectus"**) on May 24, 2004, and 400,000,000 were purchased immediately prior to the Prospectus by Bezeq Zahav Holdings, a wholly owned and controlled subsidiary of the Company, and were listed for trading in accordance with the Prospectus.

B. Deed of trust for Debentures (Series 5), dated May 24, 2004

A deed of trust signed with the Mizrachi Bank Trust Company Ltd. for a series of 600,000,000 debentures of NIS 1 par value each, repayable in six equal annual installments on June 1 of each of the years 2011 to 2016, at 5.3% annual interest, linked (principal and interest) to the CPI for April 2004. The debentures were issued by the Company, prior to the Prospectus, to institutional investors and to Bezeq Zahav Holdings, and were listed for trading in accordance with the Prospectus.

An addendum to the deed of trust for the debentures in this series relates to the issue of an additional 1,500,000,000 debentures by the Company to Bezeq Zahav Holdings on the same terms and listed for trading on the Stock Exchange (subject to lock-up restrictions).

On March 30, 2005, a further addendum to this deed of trust was signed in respect of the issue of NIS 286,967,000 par value of debentures from the same series.

2.17.2 <u>Real estate</u>

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

An agreement between the State and the Company, under which the Company was granted the State's rights in assets which the Ministry of Communications used for providing telecommunication services, and the Company assumes the rights of the State in those assets and for the obligations and liabilities relating to those rights immediately prior to implementation of the agreement. Moreover, under this agreement, the State's rights, powers, obligations and duties, as well as the contracts and transactions that were in force for telecommunications services immediately prior to application of the agreement, were transferred to the Company.

B. Settlement agreement dated May 15, 2003 between the Company and the State and Israel Lands Administration, in the matter of rights relating to real estate

See Section 2.7.4C.

C. Agreement between the Company and the Postal Authority, June 30, 2004

An agreement between the Company and the Postal Authority to define and regulate the rights of the Company and the Postal Authority in their joint assets. The agreement listed the joint assets and defined the part of each party in them. It was determined that each of the parties shall have exclusive rights in its parts, except for the matter of rights in common property, building rights or rights for which there is an explicit other determination. The agreement determines, among other things, a mechanism of right of refusal if a party wishes to make a sale transaction and a priority right for a rental transaction. For a number of additional properties, the party with exclusive rights in them, in whole, will be one named party.

2.17.3 Sundry agreements with DBS and its other shareholders[55]

See Section 5.18.4.

2.17.4 Employment agreements

A. Comprehensive pension agreement dated September 21, 1989, between the Company, the Histadrut and the joint representation of workers committees, and Makefet Fund – Center for Pension and Compensation Cooperative Association Ltd.

The agreement provides a full and autonomous arrangement in everything relating to the pension insurance of Company employees. The agreement applies to all transferred employees (who were transferred from the Ministry of Communications to the Company), to all of the members of the cumulative pension fund who are employed by the Company on the date of execution of the pension agreement, and to all of the permanent and temporary employees of the Company, with the exception of special employee groups (students, employees under personal contracts or employees working according to another, alternative arrangement).

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

A collective agreement for early retirement of employees in a pension track and an increased compensation track, under which Company employees retired in the past and which was renewed in December 2006. Sub-section F below is based, inter alia, on this agreement. For information on this matter and on the matter of early retirement, see Note 17 to the 2010 Financials,

C. Agreement to affirm rights dated September 4, 2000 between the Company, the Histadrut and the Union

A special collective agreement relating, inter alia, to affirmation of the rights of the transferred employees (who were transferred from the Ministry of Communications to the Company). This agreement affirms the rights of the transferred employees to any pension right to which they were entitled by virtue of their being former civil servants, under the Company's pension agreement, adopted by the Company as part of its pension agreement. Under this agreement, these rights become "personal rights" which cannot be cancelled except by a waiver of personal rights under law (in other words, by personal waiver by the employee himself or herself).

D. Generation 2000 agreement dated January 11, 2001 between the Company, the Histadrut and the Union

Following an amendment in July 2000 to the Hiring of Workers by Human Resource Contractors (Amendment) Law, 2000, a special collective bargaining agreement was

[55] For the purchase of shareholders' shares in DBS by Eurocom DBS, see Section 1.1.2.

signed on January 11, 2001 for hiring new employees and stipulating the terms of their salaries. The agreement applies to new employees and to employees who were previously employed at the Company through human resource companies, in positions listed in the appendix to the agreement (customer service representatives at call centers, administrative workers, typists, warehouse employees, secretaries, mail sorters and distributors etc., and similar administrative workers such as porters, drivers, forklift operators and others). Under the special collective agreement of December 2006, it was agreed that the Generation 2000 agreement would not apply to such employees who were hired by the Company after July 1, 2006. It was also agreed to insert minor amendments into the terms of employment of workers hired under the Generation 2000 agreement.

E. Agreement dated April 17, 2005 with the entity that replaced Makefet Fund in everything relating to early retirement arrangements of Company employees

On April 17, 2005 a special collective agreement was signed between the Company, the Union and the Histadrut, concerning an arrangement with a replacement for the Makefet Fund for all matters relating to early retirement arrangements for Company employees.

Subsequently, on June 28, 2005, an agreement was signed between Harel Insurance Company Ltd. (**"Harel"**) and the Company (**"the June 2005 Agreement"**), regulating pension payments in respect of early retirement and provisions for old-age and survivor pensions, stemming from legislative amendments which were part of the Israeli Economy Recovery Program Law, for employees who retired from the Company from the end of 2003 / beginning of 2004 and/or who will retire from the Company in accordance with the September 2000 special collective agreement for retirement as amended on March 18, 2004 and April 17, 2005. Following execution of the agreement with Harel, the special collective agreement referred to above between the Company, the Union and the Histadrut, was amended on the same date (June 28, 2005).

On February 14, 2008, Harel and the Company signed an amendment to the June 2005 Agreement, the main points of which were: (1) the June 2005 Agreement would also apply to Company employees who resign from their employment at the Company before December 31, 2013 in the early pension track, in accordance with an option granted to the Company in the special collective agreement of December 5, 2006, if and to the extent that the Company chooses to exercise that option; (2) reduction of the consideration paid by the Company to Harel for every retiree insured under the June 2005 Agreement for whom a policy has not been issued by Harel on the date of execution of the amendment to the June 2005 Agreement.

On this matter, see Note 17 to the 2010 Financials.

F. Special collective agreement from December 2006 and its amendment in December 2010

See Section 2.9.6.

2.17.5 <u>Management agreement</u>

Following the sale of core control in the Company (see Section 1.3.1), on April 14, 2010 the Company's management agreement with a company owned and controlled by the shareholders of Ap.Sb.Ar. Holdings Ltd. came to an end.

On June 10, 2010, the general meeting of the shareholders of the Company approved (after approval by the Audit Committee and the Board of Directors), a new agreement with Eurocom Communications Ltd., under which the Company is granted regular management and advisory services in consideration of USD 1.2 million per year. The term of the agreement is three years commencing June 1, 2010. For more details about this agreement, see the transaction report and notice of convening a special general meeting of the Company, dated June 1, 2010, which is cited by way of reference.

2.18 Legal proceedings

General – The Company's reporting policy is based on considerations of quality and of amount. In October 2010 the Company decided to raise the bar of amount materiality in the Group for its reporting, commencing October 1, 2010, so that the bar would be events affecting net profit by 5% or more of the Company's ongoing operations according to the latest annual consolidated financial statements. Accordingly, this section describes legal proceedings involving NIS 130 million or more,[56] which account for approximately 5% of net profit according to the 2010 Financials, and legal proceedings in which the amount claimed is not stated in the statement of claim, except in the case of a claim which on its face does not reach the above amount bar (and all unless the Company believes the claim has other aspects and/or implications beyond its monetary amount).[57]

<u>Proceedings which are pending at the date of publication of this report</u>

2.18.1 A number of claims are pending against the Company which concern recognition of various wage components as pension components and recognition of various components which are part of the determining wage for severance pay:

A. In September 2000, a claim was filed in the Jerusalem District Labor Court against the Company by 2,423 retired employees of the Company who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs were seeking declaratory relief determining that the payments they received for grossing up of tax, clothing allowance and incentive pay are considered part of the regular salary and therefore should be considered as part of their determining wage for the purpose of calculating their pension and the payments made to them upon retirement, and should be included in the calculation of hourly pay value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last, determining, salary for pension should be calculated according to the last salary paid (and not according to the average staff grade). The claim was subsequently amended so that all the reliefs relating to the pension rights of the plaintiffs were deleted from the statement of claim. In addition, the plaintiffs narrowed their claim to the incentive pay component and withdrew their claim for grossing up of tax and for the clothing allowance.

In January 2007, another claim was filed in the same court by 85 retirees who transferred to the Company from the Ministry of Communications, seeking declaratory relief determining that payment of the grossing up of tax, clothing allowance and incentive pay should be included in the determining salary in the matter of rights by virtue of the Hours of Work and Rest Law and the Annual Vacation Law. This claim was consolidated with the above claim.

On December 16, 2008, the court denied the claim and ruled that the premium paid to the plaintiffs is a true increment and dependent on a condition, and that the premium component should not be included also at the hour value for calculating overtime pay and redemption of annual holiday pay that is paid after the end of employer-employee relations. An appeal against the decision was filed on March 3, 2009.

B. In February 2002, a notice of a party to a collective dispute (**"the Party Notice"**) was filed in the Jerusalem District Labor Court by the Histadrut in the name of all Company employees. The applicant alleged that payments for grossing up of tax, the administrative on-call duty component and clothing allowances which were and are paid to Company employees, are regular pay which form part of the determining salary of each employee, including for the matter of calculation of payments in respect of retirement, redemption of holiday pay, bonuses, acclimatization payments, percentage increments and hourly pay value, and that various payments and provisions should be made for them, including for pension purposes. The Attorney General joined the claim. In April 2006, the court gave its decision, denying all parts of the Party Notice. An appeal was filed against the decision, in which it was alleged that the decision is procedurally void, and the hearing was returned, with the consent of the parties and the Attorney General who had joined the claim, to the District Labor Court. Subsequently, the Party Notice was struck out in view of the fact that the

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56 For reviewing claim amounts vis-à-vis this bar, the amounts were linked to the CPI. The amounted noted in this section are the original amounts (without linkage differentials). On the matter of the bar, where similar proceedings take place against a number of companies in the Group, the amount of the claim might be reviewed cumulatively in respect of all the proceedings together.

57 Legal proceedings of the Company described in the Company's 2009 Periodic report (by the section number in which the proceeding was described there), which do not meet the aforementioned bar and therefore are not described in this report and for which no updates are provided: 2.18.3, 2.18.5, 2.18.6, 1.18.8, 2.18.12, and 2.18.15.

plaintiffs' position on the need to file a new party notice was not filed in time. It was agreed that a new party notice would be filed, and that the question of the limitation date would be decided when the party notice was being heard. On February 10, 2010 a party notice was filed, which relates only to the on-call fee component. Under the party notice the Court is requested to determine that the on-call fee component be included in the hour value for calculating overtime pay and for calculating redemption of annual vacation pay.

C. A number of additional individual claims are pending against the Company, filed by employees and former employees, concerning recognition of various wage components, and mainly their recognition as pension components, and recognition of various components in the determining salary for severance pay and for overtime.

2.18.2 In January 2004, a claim was filed in the Tel Aviv District Labor Court against the Company and against the Makefet Fund, by 320 employees who retired under a retirement agreement signed in November 1997. The plaintiffs allege that they chose the Pension Track B after having been promised an increment pursuant to the "Yellow Note" agreement, and that this promise was not kept. On December 11, 2008, the decision denied the claim. An appeal filed by the plaintiffs was denied on January 1, 2010. Following denial of the claim and the appeal, on June 6, 2010 a petition filed by the plaintiffs in the High Court of Justice to set aside the decision of the National labor Court, was denied in llmine.

In March 2008 a similar claim was filed in the Tel Aviv District Labor Court by another 17 Company retirees.

2.18.3 Four claims filed in 2003 and 2005 by various plaintiffs are pending against the Company, Israel Broadcasting Corporation and the State of Israel, for compensation in respect of bodily injury and property damage caused, according to the plaintiffs, by prohibited radiation from the Hillel broadcasting station. Three of the claims are for bodily injury and are being heard in the Central District Court (the amount of the first claim is "more than NIS 15 million", the second does not provide an amount, and the third – NIS 46 million). The plaintiffs in these three claims filed an application to consolidate the hearings. The Court instructed that the proceedings be halted, and reopened if necessary only after the plaintiffs comply with the Court's decision in the matter of filing documents and affidavits. The fourth claim is being heard in the Tel Aviv District Court and is for alleged property damage and money. The amount of the original claim was approximately NIS 141 million, but due to non-payment of the court fee by some of the plaintiffs and denial of their application for exemption from the fee, some of the plaintiffs were struck from the claim so that its current amount is approximately NIS 23 million.

It is noted that on December 31, 2003, the Company ceased all broadcasts from the Hillel station, as demanded by the State and the Broadcasting Authority. And since that date the site has not been used as a broadcasting station.

2.18.4 In November 2006 a claim was filed in the Tel Aviv District Court against the Company, together with an application for its certification as a class action, in the amount of approximately NIS 189 million, alleging unlawful collection of money in cases of disconnection due to non-payment. In addition, following the opposition of the Company to broadening the claim, the plaintiff filed an additional claim in the Central District Court in February 2011, with an application for its certification as a class action, for approximately NIS 44 million, in the matter of rebate of payment for "associated services" in respect of the period in which the line was disconnected.

2.18.5 In November 2006, a claim and application for certification as a class action were filed in the Tel Aviv District Court against the Company, Pelephone, HOT, Cellcom and Partner, in the amount of NIS 158 million. The plaintiffs allege that when completing a call made from a cellular line to a fixed line, if the call is disconnected by the fixed line call recipient (and not by the cellular line call initiator), the Company and HOT delay sending the disconnection signal for about 60 seconds, and as a result, they incur a loss which is reflected in airtime costs and interconnect fees. In a procedural arrangement reached between the parties, it was decided that the claim would be heard against the Company and HOT, while the claim against Pelephone, Partner and Cellcom would be heard as part of a similar claim filed against them in August 2006 for NIS 100 million. On October 28, 2010 the Court denied the application, On December 16, 2010 the plaintiffs filed an appeal against the decision in the Supreme Court. See also Section 3.21.1B

2.18.6 In October 2008, one of the shareholders of DBS filed a claim for arbitration against the Company and another DBS shareholder, alleging losses she ostensibly incurred as a result of the conduct of the Company and the other DBS shareholder in everything relating to the management of DBS and the use of DBS for promoting objectives alien to the shareholders agreement. The plaintiff is petitioning for cancellation of the agreement, restitution and compensation. The amount of the claim is NIS 160 million.

On June 30, 2010, following the parties' application for a stay of the arbitration proceedings in view of the agreement signed by the plaintiff to sell her shares in DBS, the arbitrator decided on a stay of proceedings until receipt of further notice from the parties. According to the plaintiff's notice, upon fulfillment of the preconditions in the agreement and it coming into force, she did not wish to resume the proceedings.

2.18.7 In July 2010, a claim and application for its certification as a class action were filed in the Central District Court against the Company, alleging that the Company offers its customers to subscribe to call tracks for a fixed monthly payment from which customers for whom the track is not worthwhile incur a loss, and that the Company deceives them. The plaintiff is claiming restitution of the difference between the amount paid by the customers in the monthly track and the amount that they should have paid in the regular track, which he estimates at "tens of millions of shekels". The plaintiff is also claiming compensation of NIS 1,500 per customer for alleged invasion of privacy.

2.18.8 In July 2010 the Company received a claim and application for its certification as a class action which were filed against it in the Tel Aviv District Court. According to the plaintiff, as a result of a malfunction in the telephone lines (which was not repaired by the Company for 34 hours), Company subscribers were unable to call HOT Telecom's telephony subscribers. The plaintiff alleges that this the Company caused its subscribers various wrongs for which he is suing for compensation of NIS 100 per subscriber. The total amount of the claim is estimated by the plaintiff at NIS 250 million. The plaintiff is seeking certification of his claim as a class action in the name of the Company's subscribers. It is noted that to the best of the Company's knowledge, in 2006 an application was filed for certification of a class action on the same matter in the name of the subscribers of HOT Telecom, and that claim ended in 2009 in a settlement arrangement.

2.18.9 In September 2010 a claim was filed against the Company in the Jerusalem District Court by the Ministry of Communications, the IDF Commander in the Administered Territories and the Civil Administration in the Administered Territories, in the matter of payment of fees of approximately NIS 74 million for erecting and operating microwave trunks in the Administered Territories. See also Section 2.16.9.

2.18.10 In October 2010 a claim was filed against the Company in the Tel Aviv District Court together with an application for its certification as a class action, in which it is alleged that the Company disobeys the Consumer Protection Law in that it fails to provide its customers with a written document containing the details required under that law when agreeing on a change or addition to an ongoing transaction. The plaintiff is petitioning for a mandamus and declaratory relief requiring the Company to comply with those provisions the law and for financial reliefs (monetary or not), from October 10, 2008 to the date of filing the claim, in the amount of NIS 98 million. It is noted that in October 2010, similar claims were filed (by plaintiffs represented by the same counsel) against Pelephone, Bezeq International and DBS. On this matter, see Sections 3.2.1N, 4.20.6 and 5.20.1A.

2.18.11 In January 2011, the following four claims together with applications for their certification as class actions were filed against the Company, concerning a malfunction in the Company's network on January 25, 2011: (1) a claim estimated at NIS 104 million in the Nazareth District Court; (2) a claim estimated at NIS 135 million in the Central District Court; (3) a claim estimated at NIS 84 million in the Haifa District Court, and (4) a claim estimated at NIS 217 million in the Tel Aviv District Court.

According to the plaintiffs in these claims, Company customers were disconnected from the Company's services and were unable to make proper use of their telephone lines, as a result of which they allegedly suffered various losses.

2.18.12 In 2003 the Company filed a claim in the Tel Aviv District labor Court against the Makefet Fund for compensation in respect of breach of agreement between the Company and Makefet in the matter of calculation of the cost of early retirement of employees who were transferred to the Company from the Ministry of Communications. The amount claimed by

2.18.13 On the matter of an application for approval of a distribution that does not pass the profit test, which was filed in the Tel Aviv District Court on January 26, 2011, see Section 1.4.3

Legal proceedings which ended in the reporting period or by the date of publication of the report

2.18.14 In April 2008, a shareholder in the Company filed an application pursuant to Section 198 of the Companies Law (after his request to the Board of Directors of the Company was turned down), for approval to file a derivative claim against the Company ad a statement of claim against members of the Board of Directors of the Company who, according to the shareholder, approved a transfer of funds from the Company to DBS in contravention of decisions of Ministers of Communications, thereby causing the Company a loss of NIS 10 million (the sum that the Ministry of Communications rendered forfeit out of the Company's guarantee). On October 15, 2009, the Court's decision denied the application, and on November 26, 2009 an appeal against that decision was filed in the Supreme Court. On January 13, 2011, on the recommendation of the Court, the appellant withdrew the appeal.

2.18.15 In November 2009, a claim was filed against the Company in the Central District Court together with an application for its certification as a class action, in the amount of NIS 162 million, alleging that the collection of money for call completion service when calling 144 information service without advising that the service involves payment, is unlawful.

On May 27, 2010 the plaintiff gave notice of withdrawal of the application for certification the notice was allowed by the Court, which denied the claim and struck the application.

2.18.16 In May 2007 a claim was filed in the Tel Aviv District Court together with an application for its certification as a class action, by a plaintiff who alleged that he had purchased Company shares in 2006. The claim was filed against the Company, two former CEOs, directors who were or are serving in the Company at the times relevant to the claim, and against Ap.Sb.Ar Holdings Ltd., which at the time held approximately 30% of the Company's shares. The claim concerns an allegation that the financials statements of the Company for 200 and 2005 included false and misleading material information, including the annual profit, the fixed assets and the equity, in view of the retroactive reduction of NIS 320 million of fixed assets which were not being used by the subsidiary Pelephone. The total amount of the claim for the Group is NIS 56.5 million. An expert opinion was filed on behalf of the Court, which supports the position of the Company. On February 28, 2011 a decision was given in which the application and the claim were struck out following the plaintiff's (agreed) application to withdraw.

2.19 Business Objectives and Strategy

2.19.1 Forward-looking information

The following review of Company strategy includes forward-looking information as defined in the Securities Law, and involves assessments about future developments relating to customer behavior and needs, the pace of adoption of new services, technological changes, regulatory policy, marketing strategies of competitors, and the effectiveness of the marketing strategy of the Company.

The Company's strategy and the business objectives stemming from it are based on internal research, secondary sources of information, and primarily – the reports of research companies, publications about the activities undertaken by similar communications operators in Israel and around the world, and the work of consultants who assist the Company.

Nevertheless, it is far from certain that the strategy and the main activities described here will actually be implemented or implemented in the way described. The circumstances that could lead to non-implementation of the strategy or even its failure, lie in frequent technological changes, regulatory constraints, the formation of a sustainable business model for new services that the Company intends to provide, and a superior marketing strategy by competitors. In addition, a change in ownership of the Company could result in a change in its strategy and its business objectives.

2.19.2 <u>The strategy in brief, and intentions for the future</u>

The Company is working to realize a strategy of turning itself from a company that provides infrastructure only, to a company that provides varied products and services that suit the needs of its customers.

A. Vision and purpose

The Company's objective is to be a market leader in the domestic and business arena and to provide the customer with a total communications solution. In the private sector the Company provides such solutions for the home; in the business sector the Company provides a smart network on which a range of advanced services operate.

The objective: revenue growth in the Internet, data and new services, and steady improvement in expenses and customer service to compensate for declining revenues from telephony.

To attain this goal, the Company has set itself a number of challenges:

1. preservation of leader status in an environment of intensifying competition (leader in service and strengthening of perceived values – innovative products, reliability, proximity to the customer);
2. moderation of the decrease in revenues from core services by encouraging the recruitment of new customers and fidelity motivators among existing customers;
3. creation of new sources of income by launching new services and products;
4. adaptation of the organization to the competitive environment and operational excellence.

B. Means

To implement this strategy and attain these objectives, the Company uses and will continue to use the following means:

1. <u>Business customers</u>
   a. Diverse bundles of products and services that meets the business needs of the customer;
   b. Total solution according to customer needs, while applying a strategy of commitment to service quality and availability;
   c. Encouragement of customer to migrate from basic services to managed solutions for organizational and inter-organizational connectedness;
2. <u>Private customers</u>
   a. Wider bandwidth of customers and sale of advanced products and services on the new NGN;
   b. supply of differential debit tracks to suit customer needs;
   c. strengthening the positioning of the Company's telephony services, with emphasis on advanced applications and the penetration of advanced terminal handsets.
3. <u>Network</u>

   In order to attain its strategic objectives, the Company is working on improving the existing network and adapting it to its business goals, including by the deployment of optical fibers and by investing in the heart of the network. See also Sections 2.6.5 and 2.7.2, on the NGN.

2.19.3 <u>Development trends in the company's business</u>

A. The Company is working to increase data transfer speeds in the services it provides for its customers, and its marketing initiatives aim to transfer customers to faster Internet surfing speeds. For its business customers, the Company is also launching transmission and data communication services at high speeds and in a range of interfaces.

B. The Company is working to integrate itself into Internet protocol (IP) applications. To achieve this, it has established an IP network company to serve as a platform for the services it provides today and those it intends to provide in the future.

C. The Company has launched fixed-line and wireless home network services for surfing from a number of computers simultaneously.

D. The Company has launched a rage of debit tracks for telephony services alongside its basic tariff structure, so as to increase the extent of use of its services.

E. The Company has started marketing bundles that include additional services to those of the Company (see Section 1.7.2).

2.19.4 Main projects – planned and in progress

The Company's main projects today include deployment of the new NGN as approved by the Board of Directors, and expansion of the capacity of the Company's networks so as to provide its business customers with transmission and data communications services at high speeds.

The Company is also developing and assimilating advanced computer systems, among them a Customer Relationship Management system (CRM), a network engineering management system, and a service order and delivery management system.

2.20 Expectations for development in the coming year

As noted in Section 2.7.2, the Company foresees that by the end of 2011, the NGN will be deployed in about 80% of the country. Accordingly, investment in the network in 2011 is expected to be similar to 2010, while in 2012 the investment will be considerably smaller.

And as noted in Section 2.7.4E, from time to time the Company reviews investment in real estate that can serve as the Group's headquarters instead of leasing land. At the date of this report, no decision has been made.

The Company's assessments are forward-looking information as defined in the Securities Law, and are based, inter alia, on the Company's work plans, the pace of deployment of the NGN in the past, and on its assessment of the benefit in investment in real estate for use as Group headquarters. This assessment might not be realized, or realized in a materially different way than foreseen, in circumstances of changes in the market situation in Israel and in demand for the Company's services, material changes in the costs of deploying the network or the pace of progress in the project, and changes in the real estate market in Israel.

2.21 Risk factors

The Israeli market in which the Company operates is essentially stable. Nevertheless, there are risk factors stemming from the macroeconomic environment, from the unique characteristics of the industry in which the Company operators, and risk factors that are unique to the Company, as described in the following sub-sections:

2.21.1 Intensifying competition

Competition in domestic fixed-line communications has intensified in the past few years, both from other domestic operators and from cellular and other communications operators (see Section 2.6).

This has led to the churn of some of the Company's customers and could lead to a rise in the costs of acquiring new customers and retaining existing ones, and to Company prices being lowered and its margins falling, and consequently adversely affecting the Company's results.

The entities competing with the Company at present or those that might compete with it in the future, benefit from greater business flexibility than the Company, including the ability to cooperate with subsidiaries and affiliates for marketing joint packages of services (see Section 1.7.2). The ability of HOT to offer such packages ("Triple Play") with tariff flexibility compared with the limitations that prevent the Company from doing the same, harms the Company's ability to compete.

2.21.2 Government control and regulation

The Company is subject to government control and regulation relating, among other things, to the licensing of operations, setting permitted areas of operation, setting tariffs, operation, competition, payment of royalties, providing universal service, holding its shares, relations between the Company and its subsidiaries and a ban on interrupting or limiting its services (which could oblige the Company to provide services even in circumstances which are not economically worthwhile) – for details, see Section 2.16. This control and regulation results at times in government intervention that the Company believes impedes its business activities. Within this framework the Company is exposed to the imposition of various sanctions by the Ministry of Communications, including financial sanctions. For details about steps taken by the Ministry of Communications against the Company for ostensible violation of its Domestic Carrier license, see Section 2.16.2B.

In addition, the Minister of Communications has the authority to change the Company's license. Significant changes in the regulatory principles applicable to communications as a whole and to the Company in particular, could oblige the Company to make changes in its strategic plans, and harm its ability to plan its business activities for the long term. On possible changes following the Hayek Commission, see Section 1.7.3.

2.21.3 Tariff control

The Company's tariffs for its main services are subject to government control. Some of these tariffs are fixed in regulations, which also set a formula for updating them (see Section 2.16.1). The practical significance of this mechanism is on average real erosion of the Company's controlled tariffs. Significant changes in controlled tariffs could have a materially adverse effect on the Company's business and results. On the Hayek Commission and its agenda to review the Company's tariff structure and on the uncertainty about continuing the updating arrangement for the Company's controlled tariffs – see Sections 1.7.3 and 2.16.1. Furthermore, the limitations applicable to the Company in marketing alternative tariff packages could create difficulties for the Company in offering an appropriate competitive response to changes in the market.

2.21.4 Difficulties in labor relations and matters relating to human resources

As part of its preparation for more intense competition in the industry and increasing the efficiency of its operations, the Company must continue to make more plans for organizational changes and for further downsizing. In the past, the implementation of such plans involved, and is expected to continue to involve, coordination with the workers and significant costs, including compensation for early retirement, over and above the costs involved in existing agreements. The processes of implementation of such plans have caused and are still liable to cause unrest in labor relations and to be damaging to the Company regular activities – see Sections 2.9.3 and 2.17.4.

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

The Company's general license obliges it to ensure that its relations with its principal investees in the Group do not result in preferring them over their competitors. Separation is required between the managements of the Company and those companies, as is separation between the financial and marketing systems, assets and employees, which causes high administration overheads. In addition, the Company is limited in its ability to offer joint service bundles with those companies (see Section 1.7.2). In view of the entry of communication companies into direct competition with the Company in most of its areas of operation based on the provision of a bundle of services to the customer, whether directly or through cooperative ventures and forming "communications groups", the risk that this factor will affect the Company's operations has increased. Nonetheless, on the matter of the possibility that in the future the Group will be granted a permit to provide non-divisible bundles of services, see Section 1.7.3A. On possible changes following the Hayek Commission, see Section 1.7.3.

2.21.6 Legal proceedings

The Company is a party to legal proceedings, including class actions, which could result in it being ordered to pay significant sums, most of which cannot be estimated, and therefore, no provisions have been made in the Company’s financial statements and in those of companies in the Group for most of them. In addition, the Company's insurance policies are confined to cover limits and to certain causes, and might not cover claims for certain types of damages sustained by its customers.

Class actions against large commercial companies have become more numerous of late, notably with since the Class Actions Law came into force and expanded the causes for which a class action can be filed. Class actions can reach large amounts, as virtually all residents of the country are consumers of the Company’s services, and a claim that relates to a minor loss for a single consumer can become a material claim for the Company if it is certified as a class action applicable to all consumers or a significant portion of them. In addition, since the Company provides communications infrastructures as well as billing services to other licensees, parties suing those licensees in other class actions are also likely to try to involve the Company as a party to such proceedings. For a description of the legal proceedings, see Section 2.18.

2.21.7 Exposure to changes in currency exchange rates, inflation and interest

The Company measures exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities, based on the type of linkage. The Company's exposure to changes in currency exchange rates against the shekel is low. The Company's exposure to inflation rates is high, and therefore the Company takes steps to cover part of the inflation exposure. In addition, the Company has exposure to changes in the interest rates in relation to its borrowings.

2.21.8 Electromagnetic radiation and licensing of broadcasting facilities

The subject of the electromagnetic radiation emitted from broadcast facilities is regulated mainly in the Non-Ionizing Radiation Law (see Sections 2.15 and 2.16). The Company is working to obtain permits to set up and operate its various broadcasting installations; however, the difficulties it faces in this area, including difficulties stemming from the change in policy by relevant entities and amendments to statutes and standards, could impact adversely on the infrastructure of these installations and on the regularity of provision of services using them, and as a result, on the Company's revenues from these services. The Company's third-party liability policy does not currently cover liability for electromagnetic radiation.

2.21.9 Frequent technological changes

Communications is a field characterized by frequent technological changes and a shortening of the economic life of new technologies – see Section 2.1.5. These significance of these trends is a need to invest numerous resources in technology upgrades, especially the Company's infrastructures, a lowering of entry barriers for new competitors, an increase in depreciation rates, and in certain cases, redundancy of technologies and networks owned by the Company, the cost of investment in which is still recorded on its balance sheets.

2.21.10 Dependence on macro-factors and on levels of business activity in the economy

Stability in the financial market and the strength of Israel's and the global business economy have recently been subjected to high volatility. During 2009-2010 however, there have been signs of greater business activity and stabilization. The Company estimates that if the local market slides once again – following external or internal events – into a slow-down and a worsening of business activity, then its business results will be harmed, inter alia, as consequence of poorer revenues and the difficulty in selling its real estate assets.

2.21.11 Failure in the Company's systems

The Company provides services using various infrastructure systems that include, among others, exchanges, transmission, data communication and access systems, cables, computerized systems and others. Some of the Company's systems have backup, but nevertheless, damage to some or all of these systems, whether die to a technical fault or natural disaster (earthquake, catastrophe, fire), could cause extreme difficulties in providing service, including if the Company is unable to repair the systems. On claims filed against the Company in connection with a malfunction in its network on January 25, 2011, see Section 2.18.13.

2.21.12 Transition to the new network (NGN)

The Company is deploying its NGN, which to a large extent will replace its traditional networks. In the natural course of events, the erection of a new network based on advanced technology involves operational and business risks, such as damaging the continuity of the services provided for the Company's customers. The Company works hard to minimize the risks, inter alia by means of a comprehensive backup policy and the use of a number of suppliers in setting up the network.

It is noted that a significant part of the Company's activities (consolidated) are in its subsidiaries / affiliates. The risk factors of these companies and the assessments of their managements as to the risk factors, are described in Sections 3.24, 4.22 and 5.22.

The table below rates the effects of the risk factors described above on the Company's activities, in the estimation of its management. It is noted that these assessment about the extent of the impact of a risk factor reflects its extent assuming it is realized, and does not assess or give a weight to the likelihood of its realization. The order in which the risk factors appear above and below is not necessarily according to the rate of risk.

Table of risk factors

	Extent of risk factor's impact on Company activities		
	Major impact	**Medium impact**	**Minor impact**
Macro-risks			
Exposure to changes in exchange, inflation and interest rates			X
Industry risks			
Intensifying competition	X		
Government control and regulation	X		
Tariff control	X		
Electromagnetic radiation / Licensing of broadcasting facilities		X	
Frequent technological changes		X	
Risks unique t the Company			
Exposure in legal proceedings		X	
Difficult labor relations		X	
Limitations on relations between the Company and companies in Bezeq Group	X		
Dependence on macro-factors and on levels of business activity in the economy		X	
Failure of Company systems		X	
Transition to new network (NGN)		X	

The information in this Section 2.21 and the Company's assessments of the risk factors on its activities and business, are forward-looking information as defined in the Securities Law, The information and assessments rely on data published by the Ministry of Communications, the Company's assessments as to the market situation and the structure of competition in it, and as to possible developments in that market and in the Israeli economy. Actual results might differ significantly from these assessments if a change occurs in one or more of the factors taken into account in making them.

3. Pelephone – Mobile radio-telephone (cellular telephony)

3.1 General information about the segment of operation

3.1.1 Pelephone's segment of operation

Pelephone provides cellular communications services and sells and services terminal equipment. Pelephone's services are described more fully in Section 3.2

Pelephone is wholly owned by Bezeq.

Four companies with a general license for providing cellular services currently operate in Israel, and in September 2010 a tender was published for grant of one or two additional general cellular licenses. In addition, a number of licenses have been granted for virtual operators (MVNOs), and at last some of them are expected to launch their services during 2011.

3.1.2 Legislative and regulatory limitations applicable to Pelephone

A. Communications laws and the cellular license

Pelephone's operation is subject to regulation and control by virtue of the Communications Law and its regulations, the Telegraph Ordinance, and the general license for providing mobile radio-telephone services granted under them (**"the Cellular License"**). The Cellular License lays down conditions and principles that apply to Pelephone's activities, among them – various limitations concerning the quality and terms of the services it provides, the duty to provide interconnect services to other operators, prohibition of preference of companies with an interest in Pelephone over other license-holders, limitations on the transfer of assets used for implementation of the license, and others. The Minister of Communications of authorized to change the terms of the license, restrict it or make it contingent, and in certain cases even to cancel it, subject to the law (for details, see Section 3.18.2.).

B. Tariff control

The interconnect fees (call and text message (SMS) completion fees collected by Pelephone from other operators) are fixed in the Interconnect Regulations. The regulations were promulgated recently and reduced the fees significantly commencing January 2011 (see Section 1.7.3C).

The other tariffs collected by Pelephone from its customers are not controlled, but the types of payments it can collect from its subscribers and the mechanisms for setting regulated tariffs, are regulated in the license (see Section 3.18.2).

C. Royalties

Under its license and under the Royalties Regulations, Pelephone pays the State royalties out of its revenues from the provision of telecommunications services (see Sections 1.7.3c and 3.18.3).

D. Environmental laws and planning and construction laws

The set-up and operation of a wireless communication infrastructure, including cellular communications, is subject to the provisions of the Non-Ionizing Radiation Law and the permits from the Ministry for Protection of the Environment that are required by it, and to the provisions of planning and construction laws (see Section 3.17).

3.1.3 Changes in the volume of operation in the segment and in its profitability

For the financial and quantity data about the volume of operation and profitability of Pelephone n 2009 and 2010, see Section 1.5.4B.

In the reporting year, the number of Pelephone's subscribers increased by about 3% and monthly ARPU by about 2%, alongside a rise of about 5% in average monthly usage minutes per subscriber.[58] The upward trend in revenues from value added services, which stems inter alia from the ongoing transfer of subscribers to the HSPA/UMTS network, is continuing (see Section 3.3). The churn rate rose from 13.8% in 2009 to 15.3% in 2010, seemingly due, among other things, to the increase in competition in the field (see also Sections 3.1.4 and 3.7). In September 2010, interconnect regulations were promulgated which reduced those fees significantly commencing January 2011 (see Section 1.7.3C). Pelephone believes that the reduction of the interconnect fees could impact materially on the results of its operations, as noted in Section1.7.3C.

Pelephone's assessments as to the effects of reduction of the interconnect fees on its results are forward-looking information as defined in the Securities Law. The assessments are based, inter alia, on its market share and the volumes of its activities, on the structure of competition in the communications market and on its regulation, and on the public's consumption habits. The assessments might not be realized, or realized in a way that differs materially from projections, inter alia due to changes in Pelephone's market share or volumes of activity, changes in the structure of competition in the market or in the regulation applicable to it, or changes in the communications consumption habits of the public.

3.1.4 Market developments and changes in customer characteristics

In recent years, the cellular market has been characterized by lower growth rates than in the past due to saturation of penetration rates.

	2010*	2009	2008	2002
Number of subscribers	9,814	9,560	9,204	6,069
Penetration rate**	127%	127%	126%	92%

Source of data on number of subscribers – see Section 3.7.1

* At September, 2010.

** Penetration rate – the ratio of the number of subscribers in the market to he total population in Israel (excluding foreign workers and Palestinians, even though they are included in the number of subscribers).

As a result of the intensifying competition among the operators (see Section 3.7) and the saturation in penetration rates, the cellular market is also characterized a rise the churn rate in a way that increases the sales and marketing costs of the operators while eroding the price to the customer, even when the total number of subscribers does not fall (sine new ones sign up to replace them).

Technological developments in terminal equipment (see Section 3.1.5) and the high speed of cellular data communication and changes in the public's communications consumption habits, have resulted in an increase in the consumption of value added services (including cellular Internet).

The companies in the industry are working to increase the range of services and products offered to their customers and dedicated offers for different segments the population. In addition, the Ministry of Communications is working, by means of legislation and changes in the license, to increase competition and the entry of new competitors.

3.1.5 Technological changes than can affect the segment of operation

The cellular communications market is a dynamic area characterized by frequent technological changes in all its areas of operation (handsets, network technology and value added services). These changes impact the segment of operation ion a number of levels:

A. Erection of cellular networks in advanced technologies

Technological developments in terminal equipment and the desire to widen the range and quality of the services offered to the customer, oblige the cellular operator to periodically upgrade its network technologies. The cellular networks in Israel operate on two main technologies:

[58] For details of how the number of subscribers, the monthly ARPU and the churn rate are calculated, see the table in Section 1.5.4

1. GSM – which developed in Generation 2.5 to GPRS, in Generation 3 to UMTS and in Generation 3.5 to HSPA. The networks of Pelephone's main competitors in Israel operate in this technology.

2. CDMA – which developed on the 1XRTT and EVDO route (see Section 3.9.1).

   Until the end of 2008, Pelephone operated one network in CDMA technology. It then erected an additional network in UMTS/HSPA technology, which has been in operation since 2009. This network has allowed Pelephone to provide services requiring information transfer at higher speeds and to broaden the range of terminal equipment and roaming services. Pelephone currently operates the two networks in parallel (see Section 3.9.1).

Pelephone constantly reviews new technologies that come onto the market and the need to upgrade its existing network technologies, depending on the competition situation and the economic viability of the investment.

LTE technology (Long Term Evolution) – technology is based on an Internet Protocol that can transfer data at higher speeds than the existing Generation 3.5 technology – is currently in the initial stages of application in a small number of countries (as a data transfer, not a voice, network). Handsets and applications compatible with LTE technology are currently very limited. Furthermore, at the date of this report the Ministry of Communications has not yet formulated a policy for the designation and allocation of a frequency range for use in LTE technology. Such a policy, as well as technological developments in this area, could have a significant effect on Pelephone, This assessment is forward-looking information as defined in the Securities Law, and might not be realized or be realized differently than foreseen, inter alia in the event of formulation of a policy for designation and allocation of a suitable frequency range by the Ministry of Communications and depending on such policy and technological developments in cellular networks and their suitability to the frequency ranges in Israel.

B. Smartphones

The penetration of Smartphones – cellular phones with integrated operating systems allowing the use of advanced applications – has led to a rise in the consumption of data transfer services while increasing the supply of alternative applications and services to the Pelephone products and services provided by other entities.

C. Alternative technologies

Technologies that enable voice telephony and Internet (data) services in an IP over the cellular network (VoC) (see Section 3.1.8), could compete with Pelephone's services and materially affect its operations in the future.

3.1.6 Critical success factors and the changes occurring in them

Pelephone believes that the critical success factors in its segment of operation are these:

A. Nationwide deployment of an advanced and high-quality network, regular maintenance of the network to a high standard, and significant and regular investments in the cellular infrastructure, both for quality coverage of the whole country, which is a basic condition for providing Pelephone's services, and in order to provide customers with the most advanced services by means of the most advanced infrastructure and technology. See also Section 3.9.1.

B. The provision of advanced and diverse high-quality communications services and value added services.

C. Nationwide deployment of sales and service centers that provide the best customer support and service, for coping successfully in a competitive market.

D. Implementation of a marketing strategy that is appropriate for the changes in the industry.

3.1.7 Principal entry and exit barriers

A. Main entry barriers

1. The high penetration rate (see Section 3.1.4).
2. The need for a cellular license, the allocation of frequencies, which involves high costs and a resource in short supply (see Section 3.18.1B), and subjection of operations to the regulatory supervision that applies to the market (see Sections 3.18.1 and 3.18.2.
3. The need for significant financial resources for making heavy and ongoing investments in infrastructures, which are affected by frequent technological changes.
4. The difficulty in erecting radio sites due to regulatory limitations and public opposition.

It is important to note that the main entry barriers do not apply to potential virtual operators. Furthermore, a ender is under way for selection of another one or two cellular operators that own infrastructure, which could benefit from considerable benefits enabling entry into the segment (see Section 3.7.2).

B. Main exit barriers

1. The large investments and the time required to recoup them.
2. The commitment to provide services for customers stems from the terms of the cellular license and agreements made in accordance with those terms.

3.1.8 Alternatives to Pelephone products

The products and services that could become an alternative to some of those provided by Pelephone are these:

a. Domestic fixed-line telephone and Internet services.

b. Telephony services based on VoB/ViOP/VoC technologies.

c. Wireless Internet in public places (hotspots) by means of wireless technologies (WiFi), which could be an alternative to cellular Internet.

3.1.9 The structure of competition in the field and changes occurring in it

A. General

There are currently four operators in the cellular market: Pelephone, Cellcom, Partner and Mirs. Over the years, intense competition has developed among the operators (mainly among the first three). The competition has led to saturation in the market, reflected in smaller numbers of new subscribers, increased switching between cellular companies and erosion of the prices that Pelephone collects from its customers for the services it provides (see Section 1.5.4B).

B. Marketing service bundles by the competing cellular companies

Pelephone's main competitors – Cellcom and Partner – also operate in Internet access (ISPs) and domestic communications, and they market diverse joint service bundles (see Section 1.7.1). On the matter of acquisition of 012 Smile by Partner, see Section 1.7.1B.

C. Virtual operators

MVNO – Following the government decision in encouraging competitor in the cellular market, seven MVNO licenses have been granted to virtual operators (cellular operators that do not have their own infrastructure and will use the networks of the existing operators for providing their services). To the best of Pelephone's knowledge, other entities have submitted applications for MVNO licenses. On Pelephone's entry ino agreements with two MVNO operators, see Section 3.7.2A.

VoC operators – In December 2010 the Ministry of Communications published a hearing in the matter of setting policy for VoC services (a virtual cellular operator of telephony based on broadband), for review of the regulation of these services under an MVNO license and/or as part of a special VoB Domestic Carrier license. According to its work plan, by the end of 2011 the Ministry will announce its policy for the regulation of VoC operators, and it recently granted licenses for trial use of VoC services.

D. Entry of another operator with its own infrastructure

In September 2010 the Ministry of Communications published a tender for grant of a license and allocation of frequencies for at least one other cellular operator (or broadening of an existing license for Mirs),[59] which is expected to enjoy various benefits that will be granted to enable it to penetrate the market. Within that framework, arrangements are being considered that would allow the new operator to use the networks of the existing operators by means of domestic roaming until completing deployment of its own network, and the possibility of requiring existing operators to cooperate with the new operator in setting up network sites. See Section 3.7.2A.

E. Changes in legislation for increasing competition

Under the Arrangements Law, a number of legislative amendments were adopted, the purpose of which was to remove transition barriers among the cellular operators and to increase competition. Among these were reform in the exit penalties from commitment that the operators can collect from the subscriber, and directives relating to the neutrality of the cellular network. See Section 3.7.2D.

For additional information about the structure of competition, see Section 3.7.

3.2 Products and services

3.2.1 Services

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

Basic telephone services (voice) – Pelephone's service package includes basic call services, call completion services and auxiliary services such as call waiting, call forwarding, voice mail, voice conference call and caller ID. For details about changes in the number of customer usage minutes, see Section 3.1.3.

Value added services – Pelephone offers its customers value added services such as Internet surfing, text messages and information services using SMS (text), multimedia MMS messages, voice information services using special-purpose asterisks, information and entertainment services via the Internet portal, and advanced content services such as games, network games and video games. Pelephone also provides a navigation service and other location-based services.

The value added services offered by Pelephone are in 3G technologies that include watching television music, sports, news and entertainment channels, and the ability to photograph and forward video files. Pelephone also offers 3G services such as Internet surfing from a laptop through a cellular modem..

In December 2001, about 1.3 million Pelephone subscribers (about 46%) are subscribed in the UMTS/HSPA network, compared with 800,000 in December 2009 (29%). As a rule, the transfer of customers from CDMA to UMTS/HSPA results in their increased consumption of value added services, due to the options the network offers for services requiring data transfer in larger files and a wider range of value added services.

Roaming services – Pelephone provides roaming services (communications by means of cellular handsets from different locations around the world) in accordance with agreements it has with cellular operators abroad, enabling it to use their networks.

Until set-up of the UMTS/HSPA network (see Section 3.1.5), Pelephone was deficient in its marketing of roaming services compared with Cellcom and Partner, sine terminal equipment in CDMA technology does not support many of the overseas networks, which meant that a subscriber in the CDMA network who wished to use roaming services had to use a substitute handset which was not his personal handset.

[59] The cellular operators other than Mirs are prohibited from biding in the tender.

With the launch of the UMTS/HSPA network, Pelephone is able to offer its customers with handsets in that technology, roaming services using their personal handsets to countries all over the world, and also provides these customers with roaming coverage in 207 countries. Pelephone also provides incoming roaming services for the customers of foreign operators staying in Israel.

Servicing and repair services – Pelephone offers its customers a repair service for a monthly payment entitling the customer to a warranty for the cellular handset, or for a one-time payment at the time of repair.

3.2.2 Products

Handsets – Pelephone offers its customers various types of cellular telephone, on-board telephones and hands-free devices, as well as support for its range of services.

Pelephone also supplies its customers with modems and laptop computers for surfing the Internet through the Pelephone network,

3.3 Segmentation of revenues from products and services

The table shows data on Pelephone's revenues from its products and services (in NIS millions):

Products and services	2010	2009	2008
Revenue from services[60]	4,550	4,256	4,020
Percentage of total revenue	79.4%	79.2%	85.3%
Revenue from terminal equipment	1,182	1,120	693
Percentage of total revenue	21%	21%	15%
Total revenue	5,732	5,376	4,713

The table shows revenues from value added services out of revenue from services (in NIS millions):

	2010	2009	2008
Revenue from content and data	725	541	397
Revenue from texts (SMS)	289	241	208
Total revenue from value added services	1,014	782	605

3.4 New products

In 2010, Pelephone continued to improve and broaden the range of value added services and to increase the number of subscribers using those services, including Netstick – a surfing package using a cellular modem.

3.5 Customers

At the end of 2010, the number of Pelephone subscribers was 2.857 million (for changes in the numbers of Pelephone subscribers, see the table in Section1.5.4B). Approximately 64% of these are private customers and 26% are business customers.

Segmentation of revenues from customers:

NIS millions	2010	2009	2008
Revenues from private customers	2,899	2,751	2,437
Revenues from business customers	2,833	2,625	2,276
Total revenue	**5,732**	**5,376**	**4,713**

[60] Revenue from services includes revenues from cellular services (airtime, usage fees, call completion fees, roaming fees and others), and revenues from repair services.

It is noted that some of Pelephone's customers are pre-paid customers (who pay for communications in advance). Revenues from these customers are not material to total company revenues.

3.6 Marketing, distribution and service

Pelephone's distribution system is based on 40 service and sales centers including laboratories located around the country, which deal in service, customer sales, dealing with malfunctions or provision of a substitute handset while sending the malfunctioning handset for repair, installation of handsets, and customer retention. The distribution system is reinforced with stores and stands at 99 points of sale (some of which are operated by Pelephone employees, and others by authorized dealers). In addition, Pelephone operates through dealers who run a door to door system, and service and sales representatives for the business sector. As a rule, payment to the dealers is in the form of a commission on sales.

Pelephone's subscriber service system includes the company's website and 13 designated telephone call centers that provide information, service on various matters and in three languages, technical support, data on customer billing, value added services, sales and general information.

3.7 Competition

3.7.1 General

Pelephone operates in increasing likely competition with other cellular operators: Partner, Cellcom and Mirs. The competition has enlarged the market, added mew subscribers and eroded prices.

The table shows, to the best of Pelephone's knowledge, the numbers of subscribers of Pelephone and its competitors in 2009 and 2010 in millions of subscribers. The numbers are approximate.

		Pelephone	Partner	Cellcom	Mirs(1)	Total in market
At Dec. 31, 2009	No. of subscribers(2)	2,766	3,042	3,292	460	9,560
	Market share	29%	32%	34%	5%	
At Sep. 30, 2010	No. of subscribers(2)	2,825	3,133	3,376	480	9,814
	Market share	29%	32%	34%	5%	

(1) Since Mirs is a private company, it does not publish data about numbers of subscribers. The numbers in the table are an assessment.

(2) The numbers of subscribers are at September 30, 2010 and December 31, 2009, based on the reports of Cellcom and Partner to the public,

Regulatory moves designed to promote the entry of additional operators – one with infrastructure, and MVNOs, as well as initiatives intended to encourage customers to switch among operators (see Section 3.7.2), are expected to increase the competition in the market in the near future.

Furthermore, in light of the development of new IP-based technologies and regulatory initiatives to encourage bringing them to the Israeli market, Pelephone is likely to have to deal with more competitors from this aspect also.

The main implications of competition in cellular are price erosion, a higher churn rate – see Section 3.1.4, and the need to increase investment in infrastructure in order to be competitive.

Pelephone's assessments with regard to the effects of competition in the cellular segment, including the entry of MVNOs and one or more operators into the market, are forward-looking information as defined in the Securities Law. The assessments are based on the structure of competition in the market, the effects of changes that have occurred in it in the past and the regulatory benefits that will be granted to new operators as far as known today. It is not certain how the entry of new operators or more intense competition will affect Pelephone. The assessment might not be realized, or realized significantly differently than foreseen, inter alia due to changes in the structure of competition, various regulatory initiatives, the benefits granted to new operators, and so on.

3.7.2 Regulatory moves and legislative amendments for increasing competition in the segment

Over the past few years, the Ministry of Communications has promoted various regulatory moves for increasing competition in the cellular market, which have impacted strongly on the structure of the market and the competition in it. Below is a description of the matter promoted by the Ministry in order to increase competition in the industry:

A. Adding an operator with infrastructure

In September 2010, the Ministry of Communications published a tender for grant of frequencies and a license for cellular operators that own infrastructure (**"New Operator"**). Existing operators (as well as their affiliates) but excluding Mirs, were forbidden to bid in the tender. According to what was published, four groups submitted preliminary proposals: Mirs, Golan Telecom, Exphone, and Doron and Michael Gelfand. Completion of the tender proceedings and selection of at least one winner are expected by the end of 2011. The tender includes various benefits for the winner, the purpose of which is to remove barriers and to ease the entry of another operator.

The Arrangements Law includes an amendment to the Communications Law stating, among other things, that cellular operators that own infrastructure must allow the New Operator domestic roaming through their networks for a period of seven years, with possible extension for another three years. The law defines the maximum tariffs that an existing operator can demand from the New Operator for certain services, and also defines timeframes for deployment of the infrastructure of the New Operator. This condition allows the New Operator considerable leeway for investing in setting up the network and a relatively short market penetration period. The tender also includes a mechanism for payback of the license fees paid by the winners, on terns paid down in the tender.

In October 2010, the Ministry of Communications published a hearing on domestic roaming from its engineering / technical aspects, in order to draft an amendment to the cellular licenses that would regulate matter relating to the implementation of domestic roaming, The Ministry has not yet formulated the policy that will apply.

In March 2010 a hearing was held on the subject of sharing infrastructures by cellular license-holders. According to the Ministry's proposal, after allocation of the frequencies in the tender for a New Operator and in the time to full deployment of its cellular infrastructure, the New Operator should be allowed to use the infrastructures of the existing operators. The Ministry proposes a number of ways for this sharing, and is considering making it compulsory for existing operators to do so. In the hearing, it asks for the positions of the operators on how the sharing should be achieved.

B. Mobile Virtual Network Operator – MVNO

An MVNO is a cellular operator that does not own a cellular infrastructure and uses the network of another cellular operator to provide its customers with the service, where the extent of use of the resources of the existing operator can vary among MVNOs. During 2010, the Ministry of Communications completed its policy on MVNO and granted licenses to seven companies. Additional applications were for licenses submitted to the Ministry by various entities. It is estimated that by the end of 2011, at least two MVNOs will be operating.

At the date of this report, Pelephone has signed two agreements with MVNO license holders (Perry Telecom Ltd. and Rami Levy Hashikma Communication Marketing Ltd.), under which they will use the Pelephone network.

Pelephone believes that while the entry of MVNOs will increase competition in the cellular market (see Section 3.7.1), its agreement with the two companies will provide an additional source of income.

Pelephone's assessments with regard to the effects of the entry of MVNOs into the cellular market are forward-looking information as defined in the Securities Law. The assessments are based on the structure of competition in the market, the effects of changes that have occurred in it in the past and the regulation that will apply to

MVNOs as far as known today. It is not certain how the entry of MVNOs will be felt in practice. The assessment might not be realized, or realized significantly differently than foreseen, inter alia due to changes in the structure of competition, and changes in the regulation applicable to MVNOs.

C. Separation of cellular Internet infrastructures and the ISP

At a hearing in August 2009, the Ministry of Communications sought ways to separate the provision of access to broadband infrastructure from connection to the Internet (ISP), similar to the separation in the fixed-line network. The same topic appears in the Ministry's work plan for 2011. Pelephone believes that a decision to separate cellular Internet infrastructure services from Internet access would be to its detriment in that it currently provides the two arms of this service in the manner accepted all over the world.

D. <u>Legislative amendments</u> designed to increase competition and remove barriers to switching among operators

<u>Reform of exit penalties</u> – In an amendment to the Communications Law made as part of the Arrangements Law, commencing February 1, 2011, the amount that can be collected from a cellular subscriber in respect of termination of the agreement before the end of the commitment period was limited to 8% of the average monthly bill for services consumed during the term of the agreement to the date of its cancellation, multiplied by the number of months remaining to the end of the commitment. The amendment applies for all customers except those with more than 50 lines and who entered into an agreement with the operator before January 1, 2011, and those with more than 100 lines who entered into an agreement with the operator after January 1, 2011. The amendment also prohibits the operator, upon cancellation of the agreement by the subscriber, from demanding immediate repayment of the balance of the subscriber's payments for terminal equipment it purchased. Pelephone expects that the limitation of these penalties will serve as a further benefit in the barriers to switching operators, as well as a source of increased competition. For these reasons, Pelephone estimates that ease of switching between the companies will be reflected in a rise in the number of subscribers who sign up but also a rise in the churn rate, which in turn will result in a need for retention activities that could erode revenues from customers. On the effects of a rise in the churn rate, see Section 3.1.4.

Pelephone's assessments with regard to the effects of limiting the penalties that can be collected from a cellular subscriber, are forward-looking information as defined in the Securities Law. The assessments are based on the structure of competition in the segment and on the applicable regulation. It is not certain how the limited penalties will be felt in practice. The assessment might not be realized, or realized significantly differently than foreseen, inter alia due to changes in the structure of competition and in regulation in the segment.

<u>Network neutrality</u> – Under the Arrangements Law, a license-holder may not restrict or block the following, including by way of setting tariffs (but excluding cases in which the Minister of Communications have permission or it was specifically requested by a subscriber or group of subscribers): (1) the use of any service or application provided over the Internet; (2) features or characteristics of cellular terminal equipment; (3) the use of cellular terminal equipment in any public telecommunications network. To date, in view of the uncertainty as to the manner of application of these provisions, Pelephone is unable to assess their effects.

<u>Other legislative amendments</u> – For customers who entered into an agreement with an operator before January 1, 2011, the Arrangements Law states that no payment will be collected from them by the operator for opening a locked SIM card (to enable them to use the terminal equipment they purchased from one operator when they switch to another operator). The law also contains provisions for liberalization in the importing of terminal equipment – under the amendment, an entity trading in cellular terminal equipment who meets the terns laid down by the Minister of Communications, is exempt from a special license for such trading.

3.7.3 <u>Positives and negatives that affect Pelephone's competitive status</u>

A. Positive factors

1. A high quality cellular network with extensive deployment.
2. An advanced range of products that includes data solutions for businesses and of multimedia and entertainment services.
3. A service array and diverse service interfaces for the customer, enabling a high grade of customer service.
4. A wide distribution array that is skilled in providing appropriate solutions for every type of customer, with a skilled staff.
5. Strong capital structure and positive cash flow.

B. Negative factors

1. As a subsidiary of Bezeq, Pelephone is subject to regulatory restrictions for entering other areas of operation and expanding its service bundle for customers – regulations that do not apply to its competitors.
2. Limitations of joint activities with Bezeq, including in the marketing of joint service bundles – see Section 1.7.2.
3. The frequencies available to Pelephone might not be suitable, in certain cases, to the application of n technologies being developed in cellular technology. In view of these developments, this factor could impede Pelephone in applying new technologies, and could also impact adversely on its competitive status, taking into account other license-holders who might have different frequencies, some of which are likely to be suitable to those technologies, and difficulties involved in new frequency allocations (see Section 3.18.1B).
4. Subscribers with terminal equipment in CDMA technology cannot access roaming service in the same way as UMTS/HSPA network subscribers.
5. Inferiority to competing networks in the pre-paid market (use of terminal equipment at lower cost), stemming from the absence of a rage of low-cost terminal equipment that operates in the UMTS/HSPA network.

3.8 Seasonality

Pelephone's revenues and profitability are affected to a non-material extent by the seasons of the year. In the second and third quarters, revenues are typically higher than on the first and fourth quarters. The main reason for this is usage patterns during the summer months compared to winter, and the holiday season. Seasonality primarily affects revenues from cellular services, but as noted, not to any significant extent.

3.9 Property, plant and equipment, and facilities

Pelephone's property, plant and equipment includes infrastructure equipment of the core network, radio sites, electronic equipment, computers, vehicles, terminal equipment, office furniture and equipment, and improvements to leased premises.

3.9.1 Infrastructure

A. Pelephone currently operates communications networks in two principal technologies:

1. UMTS/HSPA, a digital technology based on the GSM standard. This technology is globally widespread, and enables subscriber identification and the provision of service by means of a SIM card, which can be transferred from one handset to another. In May 2010 an upgrade for UMTS/HSPA was launched – HSPA+. Among the advantages of this technology are is support for download speeds of up to 21 Mbps and upload speeds of up to 5.7 Mbps.[61]
2. CDMA/EVDO digital technology, which is less widespread than UMTS/HSPA and in which subscriber identification is by the identification of details burned onto his

[61] It is noted that actual surfing speed depends on a number of factors, including upgrading theist to support HSPA+ technology, the location of the site, temporary load in the network, transmission support, Internet performance, and the compatibility of the laptop and the terminal equipment.

terminal equipment rather than by means of SIM card. The CDMA network operates nationwide and enables speech, data communication and value added services.

B. The principal advantages of the UMTS/HSPA network over the CDMA network are these: the ability to provide higher surfing speeds and therefore customer consumption of more advanced and diverse value added services; the ability to make roaming services more easily available to the consumer with advance terminal equipment, and the wide selection of advanced terminal equipment that supports the network (including support in Arabic and Russian).

C. Pelephone is working to transfer existing subscribers from CDMA to UMTS/HSPA, and offers them an upgrade of their handsets to do so. It is not increasing its investments in the CDMA network beyond the needs of current maintenance. In the interim there is a certain overlap period, during which there are customers who use the two networks.

D. Engineering infrastructure such as buildings, masts and general infrastructure serve both the CDMA network and the UMTS/HSPA network. At the date of publication of this report, the infrastructure of both these networks are based on three switch farms connected to about 2,117 active radio sites (cells) around the country.

E. The UMTS/HSPA network was erected in 2008 and launched at the beginning of 2009. In that year, Pelephone also expanded the network. In 2010 expanded the network further and upgraded it to support a higher data communication capacity and also an upgrade to HSPA+. Investments in 2011 are projected to be current, including signification enlargement of network capacity, in an mount not materially different from 2010.Pelephne's assessment of investments in the network are forward-looking information as defined in the Securities Law, based on the company's work plans and its assessments of network investment needs. This forecast might not be realized, inter alia in circumstances of changes in the market situation in Israel and in demand for Pelephone's services, material changes in the costs of investing in the network or the pace of progress in the project.

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

Pelephone does not own spaces, and leases from others the areas it uses for its operations. Below is a description of the main areas used by Pelephone.

A. The areas referred to in Section 3.9.1 and used by Pelephone for setting up communications sites and network centers, are located all over the country and are leased for various periods (in many cases, for 5 years with an option to extend for another 5 years). Concerning the licensing of the sites, see Section 3.18.4

B. Some of the leased communications sites (see Section 3.18.4) are in Israel Lands Administration (**"the Administration"**) areas. Pelephone entered into an agreement with the Administration to use land in those areas for the erection and operation of communications sites. Among other things, the agreement regulates payments to which the Administration is entitled for the period to December 31, 2008. At the end of the term of the agreement and in the event of its cancellation for causes listed in it, Pelephone must vacate the site. To the best of Pelephone's knowledge, the other cellular operators have a similar agreement with the Administration,. The agreement was extended to December 31, 2009, and subsequently to December 31, 2010. At the date of this report Pelephone, and to the best of its knowledge the other cellular operators, are negotiating extension of the agreement but it has not yet been renewed. If for any reason the agreement is not extended or renewed, Pelephone could suffer significant harm, inter alia since it would be limited in its ability to erect sites in Administration property. This assessment is forward-looking information as defined in the Securities Law, and might not be realized or only partially realized, depending, among other things, on the terms of the agreement with the Administration, if signed.

C. Pelephone's head office, which has been in Givatayim since 1997, cover an area of 17,780 sq.m. In January 2010, Pelephone signed an agreement for extension of the term of the lease to December 31, 2015, which includes an option for a further extension to November 2020.

D. For sales and services, Pelephone leases 53 service centers and points of sale all over the country.

E. Pelephone has other lease agreements for its warehouses (including a main logistics enter), offices, call centers, and three network centers.

3.10 Intangible assets

3.10.1 Licenses

For details about Pelephone's cellular license and its license to operate in the Administered Territories, see Section 3.18.2.

3.10.2 Right to use frequencies

Pelephone is entitled to use frequencies by virtue of the cellular license and the Telegraph Ordinance, in the 850 MHz range for the CDMA network, and in the 850 MHz and 2100 MHz ranges for the UMTS/HSPA network. For details about the scarcity of frequencies in Israel, see Section 3.18.1B. For details about exposure to disturbances in the frequency ranges used by Pelephone, see Section 3.24.3.

3.10.3 Trademarks

Pelephone has a number of registered trademarks, the main one being "Pelephone".

3.10.4 Customer base

Many of Pelephone's customers are committed, by virtue of agreements for receipt of Pelephone's services, to periods ranging from 18 and 36 months.

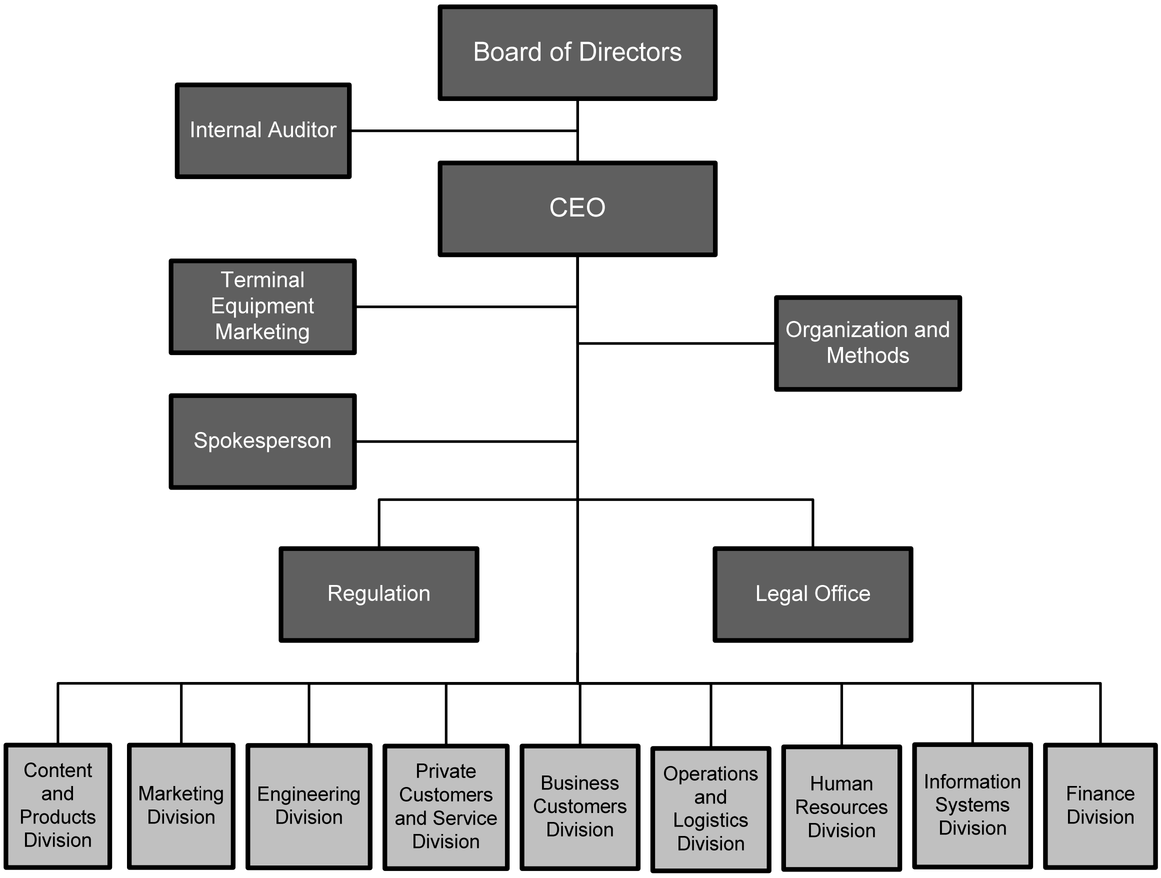
3.10.5 Software, computerized systems and data banks

Pelephone uses software and computerized systems, some of which are under purchased licenses and of which were developed by Pelephone's information systems department. Many of these licenses are limited in time, and a periodically renewed. The main systems used by Pelephone are Oracle Application and an Amdocs billing system.

3.11 Human resources

3.11.1 The organizations structure

3.11.2 of Pelephone is shown in the diagram below:



3.11.3 Headcount

The table shows the number of employees[62] at Pelephone, by organizational structure.

Department	Number of employees	
	December 31, 2010	December 31, 2009
Management and HQ	262	283
Content and product marketing	92	88
Service – Private customers	2,235	2,398
Business customers	545	547
Operation and logistics	262	253
Engineering and information systems	589	623
Total	3,985	4,192

3.11.4 Training

Pelephone invests resources in professional training for the various types of employees and the areas in which they work. Training is mainly in service, especially for the Service department. Pelephone's training expenses in 2010 and 2009 were NIS 6 million and NIS 7.5 million respectively. The employee population serving as sales and service

[62] The number of employees represents the number of positions calculated at Pelephone (total work hours divided by monthly work hours standard).

representatives and as telephone service attendants has a high turnover that necessitates constant investment in training new workers.

3.11.5 Reward plans for employees and managers

Pelephone customarily gives its employees and managers bonuses and incentive pay on a monthly, quarterly or annual basis, depending on the attainment of defined targets and on the type of work done by the employee.

On stock options plans for managers and senior employees in the Company and subsidiaries (including Pelephone) and Company phantom plans for senior managers in the Company and the subsidiaries (including Pelephone), see Sections 2.9.7B and D.

3.11.6 Employment contracts

All Pelephone employees are employed under standard personal agreements according to the professions and roles in which they are employed.

3.12 Suppliers

3.12.1 Suppliers of terminal equipment

Pelephone's stock of products includes various cellular handsets and accessories (such as laptop computers, batteries, hand-free devices, earphones, data cables, battery chargers and so on). Pelephone also maintains stocks of spare parts for its repair service, and stocks of used handsets.

Pelephone purchases some of the terminal equipment and accessories from importers in Israel, and some it imports independently. The agreements with most of the suppliers are based on framework agreements that set out, among other things, the supplier's technical support for the terminal equipment it supplies, the availability of spare parts and the repair cycle time, and the supplier's liability for the products as required by law. Most of these agreements do not include an undertaking to purchase, which is made on a regular basis by means of purchase orders according to Pelephone's needs.

If an agreement with a particular supplier of terminal equipment is cancelled, Pelephone can increase the quantity purchased from other suppliers or purchase from anew supplier. If a supplier has to be replaced, that replacement will not be immediate and will require a special preparation period for purchasing spare parts and accessories, including the ability to repair all the types of malfunctions so that customers receive the service to which they are entitled. Replacement of a supplier involves additional exceptional costs because of the different equipment and are period of adjustment with the new supplier.

The breakdown of terminal equipment purchases among the suppliers is such that no material dependence is created on one supplier or model of equipment.

In May 2009, Pelephone signed an agreement with Apple Sales International (**"the Manufacturer"**) for the purchase and distribution of iPhones in Israel. Under the agreement, Pelephone undertakes to purchase a minimum annual number of handsets over a period of three years, at the prices in effect at the Manufacturer at the time of actual purchase. These handsets are a considerable part of the quantities of handsets sold by Pelephone.

An agreement between Pelephone and Eurocom Cellular Communications Ltd, the Israeli distributor of Nokia terminal equipment,[63] regulates the purchasing and supply relations of Nokia products to Pelephone and the maintenance service for those products, through December 31, 2012. The agreement was approved by the general meetings of Pelephone and of the Company, as a transaction in which the controlling shareholder in the Company has a personal interest. For details, see the amended transaction report and notice of convening a special general meeting, dated June 10, 2010, which is cited here by way of reference,

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63 Eurocom Cellular Communications is a company indirectly controlled by Mr. Shaul Elovitz, the controlling shareholder (indirectly) in the Company.

On the limitations applicable to Pelephone in its agreements with Eurocom Group for the purchase of terminal equipment by virtue of Ministry of Communications approval of the acquisition of control in the Company, see Section 1.3.1A.

3.12.2 Added value service providers

Pelephone has agreements with content providers under which the content is provided, such as voice information, information by text message (SMS) or through the Pelephone portal, games, animation, ringtones, location services and content and rights to 3G broadcasts. As is customary in the industry, many of these agreements are based on an income distribution model between Pelephone and the content providers in respect of the services provided to customers Termination of an agreement with certain suppliers could cause delay in the provision of some of the services until an agreement is signed with a replacement provider.

3.12.3 Infrastructure suppliers

The infrastructure equipment needed for the UMTS/HSPA network is made by Ericsson, and for the CDMA network by Nortel and Motorola. Pelephone has long-term agreements for the maintenance, support and upgrading of software for the UMTS/HSPA network, and a maintenance agreement with Ericsson for the Nortel network. In the opinion of Pelephone, it could become dependent on Ericsson in connection with support for this network. Pelephone maintains the Motorola equipment independently, In addition, the cellular network uses transmission, for which the Company is Pelephone's main supplier.

Pelephone believes that the volume of purchases from it in 2010 exceeded 10% of its results.

3.13 Working capital

3.13.1 Inventory policy

Pelephone's inventory consists mainly of cellular terminal equipment (new and used), and numerous accessories (batteries, hand-free devices, earphones and the like), as well as a stock of spare parts.

The period for holding inventory is derived from Pelephone's service policy and from selling needs. These needs require that inventory be held for one to three months, depending on the types of items. At the end of 2010, stock levels at Pelephone amounted to NIS 137 million.

3.13.2 Returns policy for purchased terminal equipment

Handsets can be returned in accordance with the provisions of law (se Section 3.18.1E).

3.13.3 Policy for product warranty

Pelephone provides service, warranty and maintenance for terminal equipment in accordance with the level of repair service to which the customer is subscribed and in accordance with the provisions of the law.

3.13.4 Credit policy

Credit in handset sales transactions – Pelephone grants most of its customers who purchase cellular handsets 9suject to limitations based on parameters set by the Company), an option to divide the payments of up to 36 equal installments.

Credit by monthly debit for cellular services – Pelephone customers are debited once a month in debit cycles made on various days in the month, for conusmpti0on of the services consumed in the previous month.

From most of its suppliers, Pelephone receives credit for a period ranging from 30 days to ECM + 92 days.

Customer and supplier credit in 2010:

	Average credit in NIS millions	Average credit days
Customers*	2,226	121
Suppliers	567	43

(*) Net of doubtful debts.

3.14 Investment in affiliates and in a partnership

Pelephone has no operational investments in affiliates or active partnerships.

3.15 Financing

3.15.1 General

Pelephone's operations are financed out of cash flow from operating activities, It has long-term loans and private (non0tradale) debentures.

The average effective interest rate in 2010 for Pelephone's loans (long-term, including current maturities):

Source of financing	Amount at Dec. 31, 2010 (NIS millions)	Currency or linkage	Average interest rate	Effective interest rate
Banks	180	CPI-linked NIS	4.56%	4.61%
Non-bank	609	CPI-linked NIS	4.64%	4.69%

In 2010, no new long-term loans were taken and NIS 178 million of loans and debentures were repaid.

3.15.2 Restrictions

A. Undertakings towards banks

As part of the arrangements in connection with banks in Israel providing it with credit, Pelephone made an irrevocable undertaking to those banks to comply with financial covenants, principally these:

1. Pelephone's total debts will not exceed three times its equity.
2. If its debts exceed 2.5 times is equity and for as long as they do so, Pelephone will not distribute dividends and will not pay management fees to the shareholders. If Pelephone violates this undertaking, it must pay the bank, within 120 days from the demand, the entire credit facility provided at that date by the bank, or alternatively, it must remedy the violation by increasing its equity or repaying its debt so that the ratio is maintained.
3. Total debt should not exceed NIS 3.8 billion (linked to the known CPI in January 2002). The amount of the debt will be reviewed once every quarter as appears in the reviewed financial statements.
4. No fixed or floating charge can be imposed in any shape or form and of any type or rank, on Pelephone's assets unless it obtains the banks' prior written consent.
5. No security or charge on Pelephone's assets or guarantee to secure credit for the shareholders, can be provided for Pelephone's shareholders or any third party , without the prior written consent of the banks.

6. No loans or credit can be provided for Pelephone's shareholders, except for the parent – Bezeq, without the prior written consent of the bank, and provided that the ratio of its debts does not exceed 2.5 times its equity.

7. Undertaking to a particular bank – In addition to these covenants, Pelephone undertook to ensure that the cumulative amount of all its debts and liabilities towards a particular bank does not exceed at any time a sum equal to 40% of all its debts to financial entities, including debenture-holders.

B. Immediate repayment of a loan

The bank financing agreements include standard causes for immediate repayment of the loan, among them cases of insolvency proceedings, merger or change of control without the lender's approval, or a cross-default event.

C. Issuance of debentures

In 2004-2005, Pelephone issued three series of CPI-linked debentures by way of a private placement to institutional investors, in a total amount of NIS 1,133 million pr value, in consideration of their par value.

When the debentures were issued, deeds of trust were signed with the Union Bank Nominees Company Ltd., which served as trustee for the debenture holders through May 15, 2010. From that date onwards, Clal Finance Trusts 2007 Ltd. has served as the trustee. The debentures are not secured by a charge, and the terms of the negative pledge and Pelephone's financial covenants towards the banking system in Israel apply also to the debenture-holders (see sub-section A above). The deed of trust includes standard causes for immediate repayment of the debentures, including insolvency proceedings or violation.

D. At December 31, 2010, Pelephone is in compliance with its undertakings towards the banks and the debenture-holders.

For additional information about the composition of the loans and debentures, their terms and maturity dates, in the reporting period, see Note 14 to the 2010 Financials.

3.15.3 Credit facilities

At December 31, 2010, Pelephone has no approved credit facilities at banks.

3.15.4 Guarantees and charges

See Notes 14 and 20 to the 2010 Financials.

3.15.5 Credit rating

For issuances of debentures (see Section 3.15.2C), Pelephone was rated AA- by Midroog.

At the date of this report, Pelephone and its debentures are rated ilAA+ by Maalot, based on an assessment that Pelephone is a strong core holding in Bezeq Group.

In December 2010, S&P Maalot, which rates Pelephone's debentures, announced that it was transferring Pelephone's local debentures to CreditWatch with negative outlook, i.e. a rating of ilAA+ (AA+), due to the Company's announcement of a capital reduction of NIS 3 billion by way of a special dividend and/or a buy-back of shares.

In February 2011, S&P Maalot announced the removal of Pelephone's debentures from CreditWatch, and ratified a rating of ilAA+ with negative outlook.

3.15.6 Pelephone' assessment for raising capital in 2011 and its sources

Pelephone expects to repay approximately NIS 180 million of its loans during 2011, and plans further (current) investments in property, plant and equipment (see Section 3.9.1). Pelephone does not foresee itself raising equity or debt in 2011.

3.16 Taxation

See Note 9 to the 2010 Financials.

3.17 Environmental risks and their management

3.17.1 Statutory provisions relating to the environment and applicable to Pelephone's operations

The broadcasting sites used by Pelephone are **"sources of radiation"** as defined in the Non-Ionizing Radiation Law. The erection and operation of these sites, excluding those listed in the Schedule to the law, requires a radiation permit.

The law lays down a two-step licensing mechanism: the applicant first requests a permit to construct a radiation source (**"the Erection Permit"**), which will be in effect for no more than three months and can be extended by the commissioner for up to nine months; and then a permit to operate the radiation source (**"the Operation Permit"**), which will be in effect for five years or as otherwise determined by the Minister for Protection of the Environment in cases or under circumstances determined by him, taking into consideration the type of radiation source or its location.

For the Erection Permit, by law, provision of the permit is contingent on an assessment of the maximum radiation levels to which human beings and the environment are expected to be exposed from the radiation source, once it is operated, including in the event of a malfunction, and on implementation of the measures needed to limit the exposure levels of human beings and the environment to the radiation expected from the radiation source once it is operated, including implementation of technological means that are in use ("the Limiting Measures").

With regard to the Operation Permit, by law, grant of the permit is contingent on implementation of the Limiting Measures and to measuring the exposure levels of human beings and the environment to the radiation generated when operating the source of radiation, and the levels not exceeding the maximum exposure levels set by the Commissioner in the law. Furthermore, by law, grant of the Operation Permit is contingent on presentation of a license under the Communications Law and presentation of a permit pursuant to the Planning and Construction Law except when a building permit is not required, in which case the law directs that the applicant submit a statement to the local committee specifying the reasons that a building permit is not required for the source of radiation. If the local council engineer or district planner does not object to granting the Operation Permit within 21 days from the day the statement is submitted, the applicant must submit an additional statement stating that the aforementioned period has passed and no such objection has been made.

The law includes a punitive chapter under which, inter alia, the construction or operation of a source of radiation in contravention of the provisions of the permit and the construction or operation of a source of radiation without a permit, after having been warned in writing by the Commissioner, are strict liability offenses.

A small number of city engineers have acted according to the mechanism provided in the law and have announced that in their option, a particular access facility requires a building permit, and have objected to the grant an Operation Permit for that facility.

The law also indirectly amends the Planning and Construction Law, and provides that a building permit for a cellular broadcasting facility is contingent on the deposit of an indemnity note in respect of claims for compensation pursuant to Section 197 of the Planning and Construction Law, providing that such claim is in accordance with the directives of the National Council.

The Minister for Protection of the Environment also promulgated regulations pursuant to the Non-Ionizing Radiation Law (**"the Regulations"**).

It should be noted that regulation of the maximum permissible human exposure levels to radiation from a source of radiation and the safety ranges from communication broadcasting installations, including a limit on the placing of radiation masts on roof terraces, is still making its way through the Knesset's interior Committee for Environmental Quality, as part of a proposed amendment to the regulations which was accompanied by disagreements between the government ministries.

The drawn-out promulgation of the regulations required by Non-Ionizing Radiation Law also led to a petition to the Supreme Court, under which an order nisi was issued on June 27, 2010 ordering the Minister for Protection of the Environment and the Minister of Communications to explain why the proposed regulations should not be submitted immediately for approval by the Knesset's internal committee for environmental quality. On

October 20, 2010 the proposed wording of the regulations was placed before the committee. On January 18, 2011 the committee held a discussion of the request from the Minister for Protection of the Environment to approve the regulations which up to that date had not been approved. On February 7, 2011 a decision in the matter of the above-mentioned petition was handed down whereby there was no longer justification for the petition and it should be struck out.

As part of the policy of the Ministry for Protection of the Environment to increase its law enforcement capabilities, commencing on August 25, 2010 the ministry embarked on a pilot project which entailed the continuous supervision and monitoring of broadcasting centers. This is not external monitoring of the strength of the radiation emitted by the radio broadcasts from the base sites, but, using computer recordings from the control system in the broadcasting sites and examining them to verify the relevant broadcasting data in accordance with the system. In this context, the Minister for Protection of the Environment announced on August 22, 2010 the addition of two conditions to Pelephone's erection and operation permits whereby, inter alia, a continuous real-time computer report of all the parameters setting the radiation level created during operation of the radiation source should be sent to the Radiation Supervisor and disruptions in the operation of the software and the transfer of data to the Ministry for Protection of the Environment are prohibited. Pelephone is taking part in the pilot and applying the directives of the Ministry for Protection of the Environment in respect of this matter.

Cellular services are provided by means of a cellular phone which emits non-ionizing radiation (also known as electromagnetic radiation). Consumer Protection Regulations (Information regarding Non-Ionizing Radiation from a Cellular Telephone) 2004 ban the sale of cellular phones without the attachment of information on non-ionizing radiation and the maximum permitted radiation level in accordance with the level determined by the Department for the Prevention of Noise and Radiation in the Ministry for Protection of the Environment and as stipulated in these regulations. The regulations also require the presentation of information regarding radiation and the maximum permitted level at telephone points of sale and service centers. See also Section 3.24.2E.

3.17.1 <u>3.17.2 Legal proceedings</u>

For details of material legal proceedings allegedly relating, according to a claim made by the plaintiffs, to topics linked with electromagnetic radiation, see Sections 3.21.D, I and J. It should be noted that Pelephone's existing insurance policies do not cover electromagnetic radiation damage. In view of an explicit exclusion in the terms of the policy resulting from a global trend, it is difficult to get significant insurance cover at a reasonable cost for this matter.

3.17.2 <u>3.17.3 Pelephone's policy for environmental risk management</u>

Pelephone conducts periodic radiation tests in order to ascertain its compliance with permitted operation standards and the standards of the International Radiation Protection Agency. These tests are outsourced and performed by companies authorized by the Ministry for Protection of the Environment. Pelephone invests an average of NIS 4.5 million per year in this operation. The radiation regulations will require payment of fees amounting to approximately NIS 4 million for the granting and renewal of the permits required under the Radiation Law.

Pelephone has a procedure for supervision of implementation of the provisions of the Non-Ionizing Radiation Law whereby a senior manager is responsible for this implementation..

3.18 Restrictions on and control of Pelephone's operations

3.18.1 <u>Statutory limitations</u>

A. Communications Law and the cellular license

Pelephone's provision of cellular services is subject to the provisions of the Communications Law and its regulations. For details of the cellular permit granted to Pelephone by virtue of the Communications Law, see Section 3.18.2.

The law qualifies the Director-General of the Ministry of Communications to impose financial sanctions for various breaches of the provisions of the law and ordinances and provisions by virtue thereof, and for breaches of the terms of the permit.

B. Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance regulates the use of the electromagnetic spectrum, and applies, inter alia, to the Company's use of radio frequencies, as part of its infrastructure. Under the Telegraph Ordinance, the establishment and operation of a system using radio frequencies requires a license, and the use of radio frequencies requires designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel (inter alia, due to the allocation of a great many frequencies for security uses), by limiting the number of licenses issued for the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of frequencies on the other. The shortage of frequencies is also liable to cause difficulties in implementing certain technologies (e.g. advanced technological infrastructures such as LTE – see Section 3.1.5).

For the allocation of radio frequencies to Pelephone, see Section 3.10.2 above.

C. Arrangements Law

The Arrangements Law was approved by the Knesset in December 2010 and it amended various laws and stipulated additional provisions relating inter alia to the Communications Law and the Wireless Telegraph Ordinance. Most of the amendments linked to Pelephone's operations are provisions regarding domestic roaming services, a restriction on the exit fee a cellular carrier may collect from subscribers, network neutrality, relaxations on the import of terminal equipment and restrictions on payment for SIM card locking (see Section 3.7..2).

D. Installations emitting electromagnetic radiation – See Section 3.17.

E. Consumer Protection Law

During the course of its operations, Pelephone is subject to the Consumer Protection Law which regulates the obligations of an operator vis-à-vis consumers. In December 2010 transaction cancellation regulations entered into force. These regulations allow consumers to cancel transactions for the purchase of goods to the value of more than NIS 50 and transactions for the purchase of cellular services, within 14 days from the purchase date (subject to restrictions). Furthermore, these regulations regulate the way a payment made by the consumer for a product is reimbursed.

F. Change in interconnect fees (call completion fees)

For details of a significant reduction in the interconnect fees paid to the cellular operator, see Sections 1.7.3C and 3.1.3.

3.18.2 Pelephone's cellular licenses

A. General

Pelephone's general license is valid until September 8, 2022.[64]

Likewise, in April 2001, the Civil Administration for the Administered Territories granted Pelephone a general license for the provision of cellular services in the Administered Territories. The license is valid until October 30, 2011 and the provisions of the general license granted to Pelephone by the Ministry of Communications are applicable to it.

The following are the principal provisions of Pelephone's license:

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

[64] The text of Pelephone's cellular license is published on the website of the Ministry of Communications www.moc.gov.il

2. The license is non-transferable, and it contains restrictions on the acquisition or transfer (including by way of a charge), directly or indirectly, of control or of 10% or more of any means of control in Pelephone, including an encumbrance on said means of control, unless the Minister has given his consent beforehand.

3. Pelephone is obliged to provide an interconnect service under equal terms to all other operators and it shall refrain from any discrimination in the implementation thereof.

4. Pelephone must refrain from preference in the provision of infrastructure services to a licensee a company with an interest (as defined in the license) over another licensee.

5. Pelephone is not entitled to sell, lease or mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for certain deviations stipulated in the license (see also Note 14 to the 2010 Financials):

6. In times of emergency, whoever is statutorily competent shall have the authority to issue Pelephone with certain instructions on its mode of operation and/or manner of provision of services.

7. The license sets forth the types of payments that Pelephone can collect from its subscribers for cellular services, mechanisms for setting tariffs, reports that Pelephone must submit to the Ministry of Communications and also the duty of serving notice to the Ministry of Communications prior to modifying tariffs. The license also determines the Minister's power to intervene in tariffs, in certain cases.

8. The license commits Pelephone to a minimal standard of service, including setting up of service call centers, the determination of a maximum period for repair of malfunctions, an accounts collection procedure and protection of the privacy of the recipient of the service.

9. To secure Pelephone's undertakings and to compensate and indemnify the State of Israel for any damage caused by acts committed by Pelephone, Pelephone is required to furnish a bank guarantee for USD 10 million. The license determines the instances in which such guarantee may be forfeited.

B. Changes in Pelephone's license

As noted, the Minister is authorized to amend, add to or detract from the conditions of the license. In December 2010 the Ministry of Communications published wide-ranging amendments to the cellular licenses relating to a variety of consumer issues. Following are the principal amendments which have a significant effect on Pelephone's operations:

1. Receipt of explicit consent from content consumers by means of signature on a service access form. Pursuant to the amendment, new subscribers who fail to note their selection on the form and existing subscribers who have not responded to the form by January 2012, will be blocked by the licensee from receiving content services. This amendment requires that the Company initiate contact with its subscribers in order to receive their signatures on the form. The amendment is likely to have a detrimental effect on service to subscribers who do not manage to sign the form and to harm the Company's revenues accordingly.

2. Addition of a separate page with the principal details of the transaction for the cellular agreement, to be signed by the customer.

3. Determination of a minimum period of 10 days between the invoice issue date and the actual date on which the customer is debited.

4. Changes in the customer credit process which determine a rigid period from the date when a customer requests the credit until the Company finishes handling the customer's request.

5. Addition of the obligation to actively notify customers regarding their package usage.

3.18.3 Royalties

Pelephone pays royalties to the State of Israel out of its revenues which are liable for royalties pursuant to the Royalties Regulations. For details of an increase in the royalties percentage, see Section 1.7.3C.

In 2009 Pelephone paid approximately NIS 44 million as royalties and in the same year it paid 1.5% of its liable revenues as royalties. In 2010 Pelephone paid approximately NIS 31 million as royalties in respect of its operating activities in that year, when the percentage of royalties amounted to 1% of its liable revenues. Pelephone also paid royalties awarded against it for prior years (see Section 3.21.2A).

3.18.4 Site construction licensing

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

Pelephone deploys two main types of broadcasting sites and in two tracks: macro sites that require a building permit from planning and construction committees (see reference to NOP 36 and wireless access devices (**"access devices"**), which are exempt from a building permit in accordance with Section 27 of the Communications Law and Section 266(C) of the Planning and Construction Law, 1965 **("the Exemption Provision"**).

Building permits by virtue of NOP 36:

Licensing the construction of cellular broadcasting sites that require building permits is governed by NOP 36, which came into force in 2002.

The NOP 36 licensing process requires, inter alia, obtaining a number of approvals from government authorities and regulators, including: (a) approval for construction and operation from the Ministry for Protection of the Environment (see Section 3.17.1); (b) approval of the Civil Aviation Administration in some cases; and (c) approval of the Israel Defense Forces.

In addition, under the law, a condition for licensing the construction of a cellular broadcasting facility is that entities requesting permits submit to the local council an indemnity note relating to claims for compensation in respect of impairment of value pursuant to Section 197 of the Planning and Construction Law, and the indemnity will be a full indemnity (100%). At the date of this update, Pelephone has deposited 234 indemnity notes with various local councils in accordance with the law.

Despite NOP 36 in its existing format, Pelephone (and its competitors) encounter difficulties in obtaining some of the required approvals, and in particular approvals from planning and construction authorities.

At the same time, criticism has been leveled at NOP 36 by various entities (including the argument that it is not applicable to 3G frequencies), which has led to a proposal to amend NOP 36 in a number of rounds (**"the Proposed New NOP 36A"**).

Access devices exempt from building permits:

The second track under which Pelephone sets up broadcasting sites is the access device track. Access devices require specific radiation permits according to the Radiation Law but are exempt from a building permit if they are constructed pursuant to the conditions provided in the Exemption Provision.

Some local authorities have disputed the applicability of the Exemption Provision to access devices of a cellular network and to its use. Pelephone's position on the applicability of the exemption was accepted in a number of rulings and decisions by local affairs courts and the use of such facilities and the supporting equipment was approved. One decision in the same instance gave an opposite practice. Appeals have been filed for some of these rulings and decisions, some of which are still pending before the Supreme Court.

On September 9, 2009, the Attorney General summarized his position on the legal issue of access devices whereby the frequencies regulations for access devices which contain the exemption from a building permit for wireless access devices as prescribed in Section 266C of the Building and Planning Law, were duly promulgated by authority and by law.

Nevertheless, the Attorney General determined that in view of the legal and factual changes which have taken place over the years since the regulations were promulgated, and in view of their importance, which were discussed and clarified during the team's deliberations and in its report, the arrangement in its present format does not properly balance the interest of efficiency and competition with the interests embodied in the Building and Planning Law. The Attorney General further stipulated that the Ministries of the Interior and Communications shall, by the end of October 2009, file amendments which will prescribe conditions limiting and restricting the applicability of the exemption from a building permit and use of that facility.

On June 16, 2009, the Forum for Cellular Sanity and others filed a petition (this petition was preceded by another petition to local government from July 2008 which centered on the issue of access devices) to the High Court of Justice ("HCJ") for an order nisi to instruct the Attorney General to explain, inter alia, why the State Prosecutor's response regarding Pelephone's application for permission to appeal must not be withdrawn, and to explain why the enforcement instructions issued to the urban claimants by the Attorney General should not be cancelled, whereby indictments are not to be filed or administrative demolition orders to be issued in respect of the erection and operation of cellular access devices without building permits.

On September 9, 2010, an update notice was sent by the State to the HCJ whereby on September 7, 2010 the Minister of the Interior sent a draft of the Planning and Construction (Installation of a Cellular Wireless Communication Access Device) Regulations, 2010 (**"the Access Device Regulations"**) for approval to the Knesset Economics Committee. The proposed Access Device Regulations determine highly restrictive conditions for application of the exemption from a building permit for a wireless access device.

In a later update notice sent by the State to the HCJ on September 15, 2010, the State announced that the Attorney General believes, inter alia, that owing to the delay in presenting the Access Device Regulations for additional discussion and approval by the Economics Committee, instead of an interim order, a temporary order should be granted for the petitions which will ban the construction, with an exemption from a building permit, of additional wireless access devices used by the cellular licensees to provide cellular services, until the promulgation of access device regulations and until the entry into force of the basic arrangement stipulated therein. The Attorney General also clarified that the basic arrangement in the access device regulations reflects the desired balance between all the various considerations relevant to the matter and in light of this, if the access device regulations are approved and promulgated and the basic arrangement determined therein takes effect, he believes the HCJ will have no grounds for intervention to include the cellular frequency sector in the access device frequency regulations.

In view of the aforesaid, on September 16, 2010 the HCJ handed down a temporary injunction as requested in the notice of the Attorney General to the government dated September 15, 2010, and it was stipulated that the injunction would be valid until the entry into force of the arrangement determined in the draft access device regulations or until otherwise decided. On February 16, 2011 the HCJ qualified the temporary injunction so as to permit the cellular companies to exchange access devices which were no longer used or which were not in working order, subject to the terms laid down in the HCJ ruling. The temporary order remains in place.

Pelephone believes that if the access device regulations are approved as proposed, the option of using the exemption from building permit track in order to erect cellular access devices will be restricted to a very significant degree. A restriction of this track, together with the proposed tightening of the terms for construction of base sites in the parallel Proposed New NOP 36A track are likely to lead to noticeable tightening at the level of the obstacles restricting the construction of new broadcasting sites and access devices and even to have an adverse effect on the quality of the cellular network.

Pelephone uses access devices to provide coverage and capacity to highly populated areas. Reducing or preventing use of the access devices track in a given geographical area may have an adverse effect on service in those areas. If it is legally required that sites in a given geographic area be simultaneously demolished, service in that area is liable to deteriorate until substitute broadcasting sites can be built. As at the date of this report, Pelephone operates 499 wireless access devices.

Summary: Pelephone's ability to maintain and preserve the quality of its cellular services as well as its coverage is based partly on its ability to construct cellular sites and install information equipment, including broadcasting sites. The difficulties encountered by Pelephone in obtaining the licenses and approvals required may have an adverse effect on the existing infrastructure, network performance and on the construction of the additional cellular sites required by the network.

Inability to resolve these issues in a timely manner is liable to prevent the achievement of the service quality targets laid down in the cellular license.

A few sites constructed years ago still lack approvals from the Civil Airport Administration and the IDF, even though applications for the approvals were submitted a long time ago. Furthermore, there are administrative or other delays in some of the building and planning committees in issuing building permits to sites. Pelephone is consequently operating a number of broadcasting sites before obtaining the requisite building permits. Applications for the building permits were submitted by Pelephone to the building and planning authorities and are at various stages of discussion or approval.

Construction of a broadcasting site without a building permit constitutes a breach of the law and in some cases it has led to the issuing of demolition orders of sites or the filing of indictments or instigation of civil proceedings against Pelephone and some of its officers.

At the reporting date Pelephone has succeeded in most of the above cases in refraining from demolition or delaying implementation of the demolition orders as part of arrangements made with the planning and building authorities in order to attempt to regulate the missing licensing. These arrangements did not require an admission of guilt and/or conviction of Pelephone's officers. Notwithstanding, there is no certainty that this situation will continue in future, or that there will be no further cases where demolition orders will be issued and indictments will be filed because of building permits, including against officers.

Like other cellular operators in Israel, Pelephone might be required to dismantle broadcasting sites before the requisite approvals and permits have been obtained, on the dates stipulated in the law. . If it is legally required that sites in a given geographic area be simultaneously demolished, service in that area is liable to deteriorate until substitute broadcasting sites can be built.

3.18.5 Antitrust

The document setting out the terms of the merger between Pelephone and Bezeq includes various restrictions as to cooperation between the companies which were updated in 2010 (see Section 2.16.8D).

3.18.6 Standards

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

Pelephone complies with the requirements of Israeli Standard ISO 9001, 2008 version for mobile radio telephone (cellular) services and it undergoes periodic inspections by the Standards Institute of Israel to confirm compliance with the standard. The current certification is valid until December 2013.

Once a year, an inspection is conducted to ensure that Pelephone's operations comply with the requirements of the standard. The last inspection was in December 2010, and was successful.

3.19 Substantial agreements

For undertakings to banks, see Section 3.15.2.

For trust deeds signed with Union Bank Trust Co. Ltd. at the time of issue of debentures, see Section 3.15.2C.

For agreements with Apple and with Eurocom Cellular Communication, see Section 3.12.1.

3.20 Cooperation agreements

For cooperation agreements with content providers regarding value added services, see Section 3.12.2. For roaming agreements, see Section 3.2.1.

3.21 Legal proceedings

Following an adjustment of the Group's materiality bar as of October 1, 2010, this annual statement contains references and/or updates to legal proceedings amounting to 5% and more of the Group's net profit from current operations (approximately NIS 130 million and more[65]) according to the Company's latest consolidated annual statements, and also legal proceedings where the amount claimed was not stated in the statement of claim unless it was a claim which apparently does not meet the above-mentioned quantitative criterion (that is, unless there are additional aspects and/or implications to the proceeding beyond the financial).[66]

As part of its normal course of business legal claims have been filed against Pelephone, including applications for certification as a class action.

3.21.1 Pending legal proceedings

Following are details of the claims whose claimed amounts are material and claims which could have material implications for Pelephone's operations:

A. In December 2000, the State of Israel filed a claim with the District Court in respect of royalties allegedly owed for the period from January 1994 until February 1996. The amount being claimed is NIS 260 million, including principal, linkage differences and interest. In September 2010 a ruling was handed down against the Company which accepted some of the State's arguments. The amount the Company was obligated to pay amounted to approximately NIS 150 million, including principal, linkage differences and interest. It was paid in October 2010. Furthermore, in October 2010 Pelephone filed an appeal against the ruling in the Supreme Court.

B. In September 2001, a claim was filed at the Ramallah District Court by Paltel, the General Public Palestinian Communications Company Ltd., against Pelephone and another company.

The plaintiff alleges that inter alia, the defendants supply cellular communication services to the residents of the West Bank and the Gaza Strip, without a license, thereby violating various provisions of law and prejudicing the exclusive rights of the plaintiff.

The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority, as well as a financial action for NIS 676 million from Pelephone alone.

At the date of closing this report, the process of serving the claim was halted by the Attorney General and notice by publication which had been sent by registered mail was returned through the Ministry of Justice.

It should also be noted that Pelephone does not recognize the jurisdiction of the court in Ramallah.

Pelephone learnt that the Ramallah court may have given a decision in the claim.

According to the Emergency (Judea, Samaria and the Gaza Strip – Jurisdiction in offense and legal aid) (Territories of the Palestinian Authority – Legal Aid in Civil Matters) Order, 5759-1999, enforcement of decisions given by a court of the Palestinian Authority may only be executed if approved by the Commissioner for Legal Aid at the Ministry of Justice. Pelephone is of the opinion that such a decision – if

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65 In order to examine compliance of claim amounts with this criterion the amounts were linked to the CPI. The amounts set forth in this section are the original amounts (excluding linkage differentials) in respect of said criterion, in the event that similar proceedings are initiated against a number of companies in the Group, the claim amount is likely to be examined cumulatively for all the proceedings together.

66 Following are details of Pelephone's legal proceedings which were described in the Company's 2009 Periodic Report (by section number in this report) which do not meet the materiality bar and so they are not described in this report and updates in respect thereof will not be included: 3.21.4, 3.21.8, 3.21.10, 3.21.17 and 3.21.19.

given – was given without jurisdiction, was contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations (Judea, Samaria and Gaza Strip –Jurisdiction in Offences and Legal Aid) Law, 5727-1967.

If an attempt is made to submit this decision for the approval of the Commissioner, or to enforce it in any other way whatsoever, Pelephone will act to prevent such approval and/or enforcement of the decision and/or execution proceedings or their voidance, for the reasons noted above, which were behind the Commissioner's decision to prevent the service of the claim on Pelephone from the outset, as well as that the fact of the claim being heard in the court in Ramallah without service of process in accordance with the Order and agreement, constitutes breach of the agreement and harms the sovereignty of Israel, and that any decision given in such a claim is without effect.

C. In August 2006, a claim was filed at the District Court against Pelephone and against Cellcom Israel Ltd and Partner Communications Ltd., together with a motion to certify it as a class action, in the total amount of NIS 100 million (the **"Nachmani Claim"**).

In November 2006, a claim was filed in the Tel Aviv District Court against Pelephone and against Bezeq, Hot and Partner, together with a motion to certify it as a class action, in the total amount of NIS 159 million. Of this amount, NIS 53 million is against Pelephone, together with Bezeq and Hot (the **"Golan Claim"**). In a procedural arrangement reached between the parties, it was determined that the Nachmani Claim would be conducted against Pelephone and against Cellcom Israel Ltd. and Partner Communications Ltd., and the Golan Claim would be conducted against Bezeq and Hot, and the two procedures would be amalgamated.

The claim refers to the time of disconnecting calls made from the cellular network to the Bezeq or Hot networks. The claim alleges that in such calls, where a Bezeq or Hot customer initiates termination of the call, there is an excess charge until the call is actually disconnected. In this matter, see Section 2.18.5.

D. In December 2007, a claim was filed in the Tel Aviv District Court against Pelephone, Cellcom and Partner, together with a motion to certify it as a class action in the amount of NIS 1 billion. The claim relates to radiation damage from cellular antennae which were ostensibly erected unlawfully.

E. In July 2008, a claim was filed in the Tel Aviv District Court together with a motion to certify it as a class action. The total amount of the claim is NIS 240 million. The claim is for the refund of amounts which the plaintiffs allege was over-collected from Pelephone's subscribers, and is divided into three causes and three separate groups of plaintiffs:

First: an allegation that when making a "dial-on" call from the 144 information service (i.e. continuation of the call to the subscriber whose number was requested, without disconnecting the call), Pelephone charges for airtime also for the time until the called party answers, in ostensible violation of Pelephone's license. The amount claimed for this cause is approximately NIS 24 million.

Second: an allegation that the defendant (Pelephone) collects interest in arrears from a subscriber who is late in paying Pelephone, as well as "rescheduling" interest where payments are rescheduled, in ostensible violation of Pelephone's license. The amount claimed for this cause is approximately NIS 48 million.

Third: an allegation that Pelephone collects payment in respect of a standing order, handling fees for the voucher and commission for payment of a voucher at a service center, ostensibly in contravention of its license. The amount claimed for this cause is approximately NIS 168 million.

F. In August 2009, a claim was filed in the Petach Tikva District Court together with a motion to certify it as a class action. The claim addresses the saving of SMS messages which are sent through the Pelephone network, in Pelephone's systems. According to the plaintiffs, saving these messages is in contravention of the law and of Pelephone's license. The relief requested is as follows: declaratory relief, that the information is held unlawfully, mandamus to delete the information, an injunction to prevent messages being saved in future, as well as undefined monetary relief (to be decided by the Court).

G. In August 2009, a claim was filed in the Tel Aviv District Court together with a motion to certify it as a class action. The claim was filed against Pelephone Communications Ltd., Shamir Systems Ltd., and Unicell Advanced Cellular Solutions Ltd. The amount of the claim is approximately NIS 200 million (not divided among the respondents). The claim is for the refund of amounts collected by the respondents (which are debited through the cellular bill) in respect of services provided by the respondents Shamir and Unicell through the cell phone (information sent by SMS). The claim includes requested relief of mandamus, instructing the respondents to discontinue their practice of such debiting. According to the claim, the plaintiff did not ask to join the service offered by Shamir and Unicell, and charging for such services is therefore unlawful.

H. In October 2009, a claim was filed in the Tel Aviv District Court together with a motion to certify it as a class action. The amount of the claim is NIS 331 million. According to the applicant, Pelephone is in violation of its license by offering benefits for purchasing a handset and a refund of competitors' fines, for a period which is longer than the 18-month commitment period (to 36 months). The claim is for Pelephone to pay its customers compensation, equal to the benefits which Pelephone gives its customers during the period after the 18 months, and to instruct the company to limit the benefits it offers to 18 months.

I. In March 2010 a claim was filed in the Tel Aviv District Court together with a motion to certify it as a class action. The total amount of the claim is approximately NIS 4.2 billion and the amount of the claim against Pelephone is NIS 2.1 billion. The applicants argue that Pelephone acts in contravention of its license and the law in that it does not purchase insurance covering its liability for bodily damage arising from exposure to cellular radiation. The application also includes relief requested for an order instructing Pelephone to take out such insurance.

J. In May 2010 a claim was filed in the Tel Aviv District Court together with a motion to certify it as a class action. The claim was filed against the four cellular companies (Pelephone, Partner, Cellcom and Mirs) where the amount of the claim against each of Pelephone, Partner and Cellcom is NIS 3.68 billion and the total amount of the claim (against the four companies) is more than NIS 12 billion. The applicants argue that the cellular companies are in breach of the following duties: (1) to erect cellular antenna sites of the required scope, proportion and deployment; (2) to check, correct and provide information about the non-ionizing radiation values in cellular handsets after repair, etc.; (3) to warn against the risks involved in how the cellular handset is held. The application includes numerous other declaratory reliefs and applications for writs of mandamus relating to the above matter.

K. in June 2010, a claim was filed in the Central District Court together with a motion to certify it as a class action. The amount of the personal claim is NIS 958 (plus linkage and interest). The total amount of the action is not stated, but the application notes that it is estimated in the hundreds of millions of shekels. According to the application, Pelephone collects payment from its customers for services to which the customers have not requested to subscribe, and transfers their personal information to external suppliers without their approval, which contravenes the agreement and the law. The claim is for restitution of those moneys. The application also includes reliefs for orders instructing Pelephone, inter alia, to cease these debits and to cease transferring the information to suppliers.

L. In August 2010, a claim and a motion to certify it as a class action were filed in the Central District Court against Pelephone. The amount of the claim is not stated, but the application is estimated in the tens of millions of shekels. According to the applicant, Pelephone should refrain from collecting Value Added Tax from customers who use its services when they are outside Israel. The application also includes the relief of an order instructing Pelephone to cease charging its customers for the services they use outside Israel, and an order instructing that the moneys collected to date be restituted.

M. In October 2010, a claim and a motion to certify it as a class action were filed against Pelephone and others in the Tel Aviv District Court. The amount of the claim against Pelephone is NIS 1.6 billion, out of a total of NIS 3.2 billion. The claim is for the restitution of amounts collected by the respondents (and debited by means of the cellular phone bill), for services provided by respondents Unicell, Telemeser and Select by cellular telephone. The claim alleges that the applicants did not request to subscribe to the services of those respondents and therefore the debit in respect thereof is unlawful.

N. In October 2010, a claim and a motion to certify it as a class action were filed against Pelephone in the Tel Aviv District Court, alleging that Pelephone is acting in contravention of the Consumer Protection Law by failing to provide its customers with a written document containing the details required under the Consumer Protection law, when entering into an agreement for changing or adding to a continuing transaction. The plaintiff is applying for a writ of mandamus and declaratory relief which will direct Pelephone to comply with the provisions of the above-mentioned Consumer Protection Law and also for monetary reliefs from October 2008 until the filing of the claim in the amount of NIS 98 million. For details of similar claims filed against other Group companies by other plaintiffs represented by the same lawyer, see Sections 2.18.10, 4.20.6 and 5.20.1.

O. In January 2011, a claim was filed in the Jerusalem District Court together with an application for it certification as a class action in the amount of NIS 150 million. According to the applicant, he purchased two Samsung handsets but us unable to use them for surfing the Internet even though he purchased surfing services. The amount of the action reflects, according to the plaintiff, harm to his family and work.

3.21.2 Procedures concluded in the reporting period

A. In December 2002 a claim and an application to certify it as a class action were filed in the Tel Aviv District Court against Pelephone and Cellcom in the amount of NIS 4 billion, of which NIS 2.4 billion against Pelephone.

The claim relates to amounts collected by Pelephone and Cellcom for interconnect fees for incoming calls between May 10, 1996 and October 2, 2000. It alleges that each cellular carrier has a monopoly on its incoming calls coming; Pelephone and Cellcom abused their monopolistic status by setting high and unfair prices for such calls; the correct and appropriate tariff for such calls is NIS 0.25 per minute, and not as collected in the past by Pelephone and Cellcom, or as presently determined by the interconnect regulations. In December 2008 the claim was deferred. In January 2009 the plaintiffs filed an appeal. In May 2010 the appeal was denied.

B. In June 2007, a monetary claim and a motion to certify it as a class action were filed in the Tel Aviv District Court against Pelephone.

The aggregate amount of the claim is NIS 239 million and it relates to a group of Russian customers who were offered plans which are the subject of the claim. The plaintiffs argue that Pelephone deceived the “World Plan” subscribers, in other words, that the plan framework provided for them to be billed on the basis of 12-second dialing units, while in actual fact, these subscribers were billed on the basis of one-minute dialing units. They also claim that Pelephone failed to attach to the agreement documents the plan’s tariffs, as required by its license, with the aim of achieving the purpose of the deception. In July 2010 the claim was dismissed.

C. In May 2008, a monetary claim in the amount of NIS 479.5 was filed in the Tel Aviv District Court (the statement of claim is headed “Class Action” but it does not contain the amount claimed from the whole group and it does not contain separate services of process – “Statement of Claim” and “Motion to Certify a Claim as a Class Action”, as required). As stated above, the total amount of the claim is not defined in the claim. Pelephone is defendant no. 2 while defendant no. 1 is the Israel Only 5 Lotto Club Company Ltd.

The claim is for the restitution of sums by defendant no. 1, which according to the plaintiff, were claimed by it, via Pelephone, from subscribers of its “Customer Club” for services it provided to these customers. The plaintiff argues that in an agreement between defendant no. 1 and the members of the Customer Club, which was the basis for adding them to the club and collecting moneys from them, there were flaws, and consequently the above amounts should be reimbursed to the subscribers. The specific argument against Pelephone is that the debit for the services of defendant no. 1 is not clearly distinguishable in the bill sent by Pelephone to its customers, allegedly in breach of Pelephone's license. In August 2010 the claim was dismissed.

D. In January 2009 a claim and a motion to certify it as a class action were filed in the Tel Aviv District Court in the total amount of NIS 219 million (plus compensation for mental anguish to be determined by the court).

The claim is for the restitution of amounts collected by the defendant from its subscribers, as argued by the plaintiff, for surfing by representatives of the defendant on a handset while it was being repaired. In January 2009 a claim a claim and a motion to certify it as a class action were filed in the Tel Aviv District Court in the total amount of NIS 570 million. The claim is for the restitution of amounts collected by the defendant from its subscribers, as alleged by the plaintiffs, for surfing on a handset in order to back up the phone book, carried out by representatives of the defendant while the handset was being repaired. The grounds for the claim are similar and even appear to parallel the grounds of the above claim. In June 2010 the claims were dismissed after the claim was removed in the framework of a settlement agreement.

E. In August 2009, a claim and a motion to certify it as a class action were filed in the Central District Court. The claim is for the restitution of amounts collected by Pelephone for payment by standing order, and it is argued that this collection is contrary to Pelephone's license and the law. The amount of the personal claim is NIS 173. The amount of the class action is not stated. The claim contains relief requested in the form of a “permanent injunction” instructing the respondent to cease collecting the amount, and “declaratory relief” that its collection is unlawful. In December 2010 the claim was dismissed and the plaintiff was billed for costs.

3.22 Business objectives and strategy

Pelephone’s principal strategic objectives are these:

3.22.1 Growth of data services

A. Increasing revenues from data services by increased marketing of mobile devices, cellular modems (NetStick) and smartphones.

B. Marketing data (internet) packages.

C. Increasing data transfer speeds.

3.22.2 Growth of value added services

A. Development of unique applications

B. Marketing of existing applications such as satellite navigation services (GPS), music library (Musix) and TV channels (Super TV)

3.22.3 Continued encouragement of customers to migrate from the CDMA network to UMTS/HSPA network.

3.22.4 Increase customer satisfaction

3.22.5 Constant improvement of network infrastructures

3.23 Outlook for development in the coming year

In 2011, a number of negative and positive factors are expected to affect Pelephone’s activities, the main ones being:

3.23.1 Regulation

In 2011, Pelephone expects revenue to be adversely affected by regulation of policy, license amendments, consumer legislation and various administration provisions which have recently taken effect, including a reduction of the interconnect fee, the introduction of MVNO, which are liable to harm market share and cause a decline in tariffs, restrictions on exit fees (see Section 3.7.2D).

3.23.2 Innovative value-added services

In 2011, Pelephone is expected to continue to improve its existing services and to widen its range of advanced value-added services which will help improve brand perception and increase revenue from existing customers.

3.23.3 Increase in revenues from value added services

Pelephone expects that during 2011, it will continue to increase the number of customers using 3G on the HSPA/UMTS network, it will expand the supply of services, and as a result Pelephone will continue to increase its revenue in this sector.

Pelephone's above assessments of developments in the year to come are forward-looking information as defined in the Securities Law. These assessments are based, inter alia, on the state of competition in the cellular sector, the existing regulatory situation and the manner in which innovative changes are implemented in regulation, the Company's assumptions and forecasts with regard to the speed of entry into the cellular market of the MVNO operators, the Company's forecasts in connection with the continued demand for advanced value-added services and the continuation of growth in the number of subscribers using 3G services on the UMTS/HSPA network. These assessments might not be realized or might be realized in a materially different manner from the one already described, depending, inter alia, on the structure of competition in the market, changes in the consumption habits of cellular customers and regulatory developments in the segment.

3.24 Risk factors

The Israeli market in which Pelephone operates is stable by nature, however, there are risk factors deriving from the macro-economic environment, the unique qualities of the sector in which Pelephone operates, and risk factors that are unique to the Company.

3.24.1 Macroeconomic risks

Exposure to changes in exchange rates, interest rates and rates of inflation – Pelephone is exposed to risks due to changes in the exchange rates, as most of its terminal equipment, accessories, spare parts and infrastructure are purchased in US dollars, whereas Pelephone's revenues are in shekels. An erosion of the shekel against the dollar may affect Pelephone's profitability if it is unable to adjust the sale price in the short term. Pelephone's loans and debentures which are linked to the CPI bear fixed interest so that any change in the interest rate will affect their fair value but not their book value.

3.24.2 Sector risks

A. Investments in infrastructure and technological changes – The cellular market in Israel and in other countries is characterized by material capital investments in the deployment of infrastructure and in subscriber equipment. The frequent technological changes in infrastructure and terminal equipment and the fierce competition in various market segments impose a heavy financial burden on the companies operating in the market, requiring them to update their infrastructure technology from time to time or to introduce new devices into the market at heavy cost.

B. Customer credit – Pelephone's sales to its customers are mostly credit-based. Most of this credit, which is not covered by either insurance or sureties, is exposed to risk. Due to the wide distribution of its customers, Pelephone believes that there is a low risk of substantial harm to its business results.

C. Regulatory developments – In the area of Pelephone's operations, there is a trend to legislate and impose standards on issues such as the environment, increased competition, tariffs, product liability and the methods used for repairing products. These regulations might, inter alia, make it much more difficult to construct cellular sites, impairing network quality, and increasing the costs of services and marketing. Due to the strong competition, it might not be possible to roll those costs in full onto consumers, which could erode profits in the sector. Furthermore, regulatory intervention and the uncertainty it entails may have an adverse effect on the Pelephone's ability to plan its business activity.

D. Competition – The cellular market in Israel is characterized by a high degree of saturation and strong competition, and is exposed to influences due to technological and regulatory developments (see Section 3.7).

E. Electromagnetic radiation – Pelephone operates hundreds of transmission facilities and sells terminal equipment that emits electromagnetic radiation (see Section 3.17). Pelephone is taking steps to ensure that the levels of radiation emitted by these transmission facilities and terminal equipment do not exceed the levels of radiation permitted in the directives of the Ministry of Environment Protection (levels adopted in accordance with international standards). Even though Pelephone acts according to the directives of the Ministry of Environment, if health risks are found to exist or if the transmission sites or terminal equipment are found to emit more radiation than that allowed in radiation standards, constituting a risk to health, this could have a negative effect caused by a reduction in the use of Pelephone's services, difficulty in renting sites, compensation claims for physical and property damages in substantial amounts and attempts to exercise the deeds of indemnity that were deposited with the planning authorities with respect to section 197 of the Planning and Construction Law. Pelephone's third-party liability policies do not currently cover electromagnetic radiation.

F. Site licensing – The establishment and operation of cellular antennas are subject to building permits from the various planning and building committees, a process that involves, inter alia, a number of approvals from State entities and regulatory bodies. For details of the difficulties encountered by Pelephone in the establishment and licensing of sites, see Section 3.18.4. These difficulties may impair the quality of the existing network and even more the deployment of the new network.

3.24.3 Pelephone's risk factors:

A. Terminal equipment quality – Pelephone might be exposed to losses in the event of malfunctions in the terminal equipment that it sells, including indirect damages that could result from such malfunctions.

B. Property risks and liabilities – Pelephone is exposed to various property risks and liabilities. Pelephone employs the services of expert professional external insurance consultant in this field. Pelephone has insurance policies which cover the usual risks which Pelephone is exposed to within the limits of the conditions of such policies, including various forms of property insurance and liability insurance, loss of profits, third party liability insurance and officers' insurance. However, its policies do not cover some types of risk, including certain faults arising from negligence or human error, radiation risks, terror, etc.

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

D. Serious malfunctions in the communications network – Pelephone's communications network is deployed around the country through network core sites, antenna sites and other systems. Pelephone's business is totally dependent upon these systems. Wide scale malicious harm or malfunction might adversely affect Pelephone's business and results.

E. Damage by natural disasters, war, catastrophe - damage to the switching farm and/or servers used by Pelephone for its core activities could have an adverse effect on Pelephone's business and its results.

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

G. Pelephone uses two frequency ranges: 850 MHz and 2100 MHz. In certain situations Pelephone's frequency inventories might not be suited to the implementation of new technologies emerging in the cellular communication sector in a manner which could make it difficult for Pelephone to implement them. This would have having an adverse effect on Pelephone's competitive status, since the other licensees have a different frequency inventory, some of which might suit those technologies and on the difficulties entailed by the allocation of new frequencies (see Section 3.18.1B). Furthermore, the frequencies are exposed to interference and could impair service quality of networks operated by Pelephone. The factors that could cause interference include the fact that the 850 MHz frequency is also used for terrestrial television broadcasts, television stations broadcasting in the Middle East (mainly in Cyprus) on the same frequency, causing interference in Pelephone's 850 MHz EVDO/XRTT1 and UMTS/HSPA networks.

Below is a chart grading the effect of the above-mentioned risk factors on Pelephone's operations, as assessed by Pelephone's management. It should be noted that Pelephone's assessments of the effect of a risk factor reflect its effect based on the assumption that the risk factor will be realized. Nothing in the aforesaid expresses an assessment or gives weight to the chances of such a realization. The order in which the risk factors appear above and below is not necessarily in accordance with the extent of the risk.

Effect of risk factor on all of Pelephone's activities			
Risk factors	**Major**	**Moderate**	**Minor**
Macro-economic risk factors			
Exposure to changes in the exchange rates, interest rates and inflation		X	
Sector risk			
Investments in infrastructures and technological changes	X		
Customer credit			X
Regulatory developments	X		
Competition	X		
Electromagnetic radiation			
Site licensing	X		
Pelephone's risk factors:			
Quality of terminal equipment		X	
Property risks and liabilities			X
Serious malfunctions in information systems	X		
Serious malfunctions in the communications network	X		
Damage caused by natural disasters	X		
Legal proceedings		X	
Restrictions applicable to frequencies and disturbance in frequency use		X	

The information contained in Section 3.24 and Pelephone's assessments of the effect of risk factors on its operations and businesses is forward-looking information as defined in the Securities Law. The information and assessments rely on data published by the Ministry of Communications, Pelephone's assessments of the market situation and its competitive structure. With regard to possible developments in the market and in the Israeli economy, the actual results are likely to be materially different from the above assessments if there is a change in one of the factors taken into account in making them.

4. Bezeq International – international communication and internet services

4.1 General

4.1.1 Structure and changes to area of operations

Bezeq International operates in a number of key areas: supply of Internet access services (ISP); supply of international telephony services; domestic telephony services, based on the Internet infrastructure (VoB); supply of NEP services; supply of ICT (Information and communication systems) and data transfer services.

The international telephony services of Bezeq International, similar to those of the international operators which are its competitors, are supplied mainly via the Company's domestic network and the cellular networks, for connecting the subscriber to the international exchange.

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The areas of operation of Bezeq International are primarily regulated by the Communications Law and its regulations, and the communications licenses awarded to Bezeq International (see Sections 4.17.1 and 4.17.2). Moreover, Bezeq International is subject to consumer legislation.

For the key regulatory developments applicable to Bezeq International, see Section 4.17.6.

4.1.3 Changes in the sector's volume of operations and profitability

For information regarding changes in the scope and profitability of Bezeq International's operations, see Section 1.5.4C.

4.1.4 Market developments and customer characteristics

The international call market in Israel has in recent years been characterized by a decline in call volume – in 2010 the volume of call minutes (incoming and outgoing) declined by an average of 5%. In 2009 an average decline of 3.1% was recorded compared with 2008.

In the Internet market in 2010, there was a continuation of the trend toward a slowdown in the growth rate in light of the high penetration percentage (approximately 73% of Israeli households are connected to the Internet), alongside a rise in bandwidth. As a rule, an increase in demand for higher bandwidth requires an increase from time to time in the capacity acquired by Bezeq International in order to provide its services (for details of the principal infrastructure providers of Bezeq International, see Section 4.12.2).

4.1.5 Main entry and exit barriers

A. The main entry barrier in the international call market is the requirement for a license under the Communications Law and investments in infrastructure (the volume of investments in infrastructure is lower than the volume of investments in a domestic carrier or cellular infrastructure), which is affected by frequent technological changes. However, changes in the licensing policy, as set forth below, and expansion of the use of VoIP technology in this field, significantly reduces the effect of these barriers.

B. The main entry barrier into the data and internet services market stems from investments in infrastructure (international capacity, access to the internet network and the operation of large scale customer service call centers).

C. The main exit barriers for these markets stem from long-term agreements with infrastructure suppliers and from investments that require long periods of time to provide returns. Furthermore, Bezeq International is committed to providing service to its customers throughout the period of their contract.

4.1.6 Substitutes for Bezeq International products

In the international call market, the use of VoIP technology enables transfer of international calls over the internet, for other users of this technology, as well as for TDM network users, through the use of software products (such as Skype) and services of overseas communication providers. The attractive cost of using these services leads to a steady growth in the number of users, and as a result – a decline in the revenues of Bezeq International. Furthermore, some service providers operating in the international call market do not have a license (illegal operators) and therefore are not subject to the restrictions imposed on Bezeq International by virtue of the license and the provisions of the law.

4.1.7 Structure of competition and changes in the sector

A. In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. By 2004 other international carriers had entered the market, some of which subsequently merged. At present five international carriers operate in the Israeli international telephony arena.

B. During the fourth quarter of 2008, Partner entered the arena of internet access and IP-based content and telephony services and began marketing its products to the general public on January 1, 2009. This meant that Partner became a competitor in the markets in which Bezeq International operates.

C. In December 2010 Hot-Net obtained a special license to provide ISP services – see Section 1.7.1C.

D. To date, licenses to provide internet access services have been granted to approximately 70 companies, three of which are the aforementioned international operator licensees.

E. For details of Partner's transaction for the acquisition of 012 Smile, see Section 1.7.1B. The completion of the transaction (if it is completed) is likely to have implications for the markets in which Bezeq International operates. For the entry of cellular operators into the international call market, see Section 4.17.6A.

4.2 Products and Services

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

4.2.1 Internet services

In the internet services sector, Bezeq International provides internet access services for private and business customers, including terminal equipment and technical support, with an emphasis on broadband internet based on ADSL or Hot's optic cable infrastructures; hosting services – website and server hosting services in a designated data center facility for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' internet and LAN connections using the required terminal equipment or software, including monitoring; data services with international data communication IP solutions for business customers, including global deployment where required; and wireless (WIFI) access – fast wireless access solutions for private and business customers, including in various public locations (hotspots).

4.2.2 Voice (telephony) services

In the voice services sector, Bezeq International provides international direct dialing (IDD) services to business and private customers; toll-free number services for business customers overseas; international call routing and termination services (hubbing) – transfer of international calls between foreign communication providers (worldwide), calling card services enabling prepaid and postpaid dialing from and to Israel , for business and private customers; and the 1809 service for dialing from Israel to other countries. Bezeq International also provides domestic telephony services by means of VoB (Voice over Broadband) access.

4.2.3 International data services

Supply of international data communication solutions for business customers includes customized global deployment.

The customer is able to choose from a range of the most advanced data communication methods through the optic cables deployed from Israel to Europe for which Bezeq International has long-term usage rights and business partnerships with leading global telecom providers such as BT, which make available to its customers their sophisticated global network services.

4.2.4 ICT solutions for business customers

Bezeq also provides ICT (Information and Communication Technology) solutions for business customers; as part of an overall ICT solution for businesses Bezeq International provides broad communications services, including international data and communication services, server and website hosting services, technical support and maintenance services, network and system services, outsourcing and out-tasking services, security and risk management solutions and managed IP services.

4.2.5 PBX services

Following the merger with BezeqCall, Bezeq International markets and maintains communication systems in the Israeli market, telephone exchanges (PBX), telephony and IP communications networks. As part of the service contracts, Bezeq International supplies direct maintenance of a range of exchange manufacturers. The services are given to gateways, telephone exchanges and network end points (NEP) designated for use with both internal and external lines.

4.3 Revenue

Bezeq International's revenue (in NIS millions):

	2010	2009	2008
Revenues from international carrier services	501	502	502
% of total Bezeq International revenues	36.3%	38.1%	38.4%
Revenues from internet and communication services for businesses (ISP, ICT, data)	879	816	804
% of total Bezeq International revenues	63.7%	61.9%	61.6%
Total revenue	**1,380**	**1,318**	**1,306**

4.4 New Products

In January 2009, Bezeq International inaugurated a new data center in Israel. The new data center joins the existing data centers (IDC) and is expected to host thousands of servers. The establishment of the new data center is part of Bezeq International's strategy to become well established in the business sector, especially among small and mid-sized businesses which now prefer to use outsourcing for their IT requirements and prepare to be at the forefront of the cloud computing sector[67]. The new data center established by Bezeq International is a "green" facility based on energy saving infrastructures. The data center utilizes Bezeq International's advantages as a leading internet services provider in Israel by being directly connected to the backbone of the company. In this way, customers can benefit from maximum flexibility in managing their bandwidths and from a wide range of sophisticated services such as server hosting and management, virtual servers and a range of managed services – backup, information security, hacking prevention, monitoring, provision of usage statistics data, domestic and overseas bandwidth load balance, burstable broadband service, FTP file transmission services and more.

[67] Cloud computing – supply of IT services via the internet when all the customer's computer systems, including applications, data and equipment, are located at and operated by the service provider in order to reduce the costs of purchasing and managing computer systems.

4.5 Customers

Bezeq International does not derive any revenues of a single customer which exceed 10% of its total revenues. Below is a breakdown of revenues from private and business customers:

NIS millions	2010	2009	2008
Revenues from private customers	523	520	513
Revenues from business customers	857	798	793
Total revenues	**1,380**	**1,318**	**1,306**

4.6 Marketing, distribution and service

4.6.1 Marketing

The marketing department manages its operations using a limited number of permanent suppliers, among them advertising companies representing Bezeq International, through which Bezeq International manages its purchases from advertising media (television, internet, radio and the daily national press), production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies. Bezeq International believes that the loss of contact with any of its permanent advertising or marketing suppliers will have no significant effect on its marketing and distribution channels.

4.6.2 Private market sales channels

A. Telephone recruitment and retention centers for internet and telephony service customers.

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

C. Technical support and service centers for customers by means of telephone service and support centers.

D. Distribution channel setup including external centers and field teams operating resellers and dealers.

E. Sale of Bezeq International services by the Company in the form of joint service bundles (see Section 1.7.2B).

4.6.3 Business market sales channels

These channels include customer recruitment centers, business service and technical solution presale and postsale centers, and customer managers suited to customer type (SMB, SME customers designated for outsourcing transactions, etc.).

4.7 Competition

The main characteristic of market competition in 2010 was the merging of communication groups and offering of customer tailored comprehensive services and products – see Section 1.7.1.

Competition is characterized by a particular trend of tariff erosion.

4.7.1 International telephony services

A. At the end of 2010 there were five licensed competitors in the market: 014 Bezeq International, 013 NetVision, 012 Smile, 018 Xfone and Telzar International Communication Services.

Bezeq International estimates that its market share in outgoing international calls from customers is approximately 30.8% compared with a market share of approximately 31% at the end of 2009.

B. General characteristics of competition in 2010

1. A decline in call minute volume (see Section 4.1.4).
2. About 50% of households make international calls at least once a month.
3. The competition centers on various sectors of the population.
4. The product is a commodity.
5. The fierce competition and penetration of VoIP technology (such as Skype) increase competition for customers.

4.7.2 <u>Internet access services</u>

A. Bezeq International's competitors in this market, include 013 NetVision, 012 Smile, Partner, which announced that after completing its acquisition of 012 Smile it wishes to merge its operation in this sector with 012 Smile (as described in section 1.7.1B) and two minor niche players whose share is not material. Moreover, in December 2010 an ISP license was granted to HOT-Net.

Bezeq International believes that its market share in the ISP sector is 37%, the same as at the end of December 2009.

B. General characteristics of competition in 2010:

1. High penetration – approximately 73% of households in Israel are connected to the internet.
2. There are two alternatives for customers in the market: Bezeq's ADSL and the HOT cable infrastructure.
3. HOT frequently cooperates with Bezeq International's direct competitors. In addition, as noted above, HOT intends to initiate its own internet access operations through its subsidiary, HOT-Net Internet Services.

C. Developments in 2010:

1. Continued slow-down in the growth rate of broadband internet compared to previous years.
2. Upgrade of the internet infrastructures (Bezeq and HOT) and increased bandwidth offered to customers – Bezeq's NGN network and HOT's UFI network (DOCSIS 3.0) enables internet access providers and infrastructure providers to offer a range of bandwidth from 10Mbps up to 100Mbps.
3. Strengthening of the trend of selling service bundles. This means that infrastructure suppliers have an effect on market behavior.
4. Continuation of the trend toward a rise in the sale of value-added services.
5. In view of the market saturation, an emphasis is placed on strengthening customer loyalty.

4.7.3 <u>Communication solutions for the business sector</u>

With the aim of increasing revenues from business customers, Bezeq International continues to supply ICT (Information Communication Technology) services to businesses, providing comprehensive solutions in areas such as system, networking, IT, hosting, telephony, data, Internet access and wireless networks.

A. <u>ICT</u> – In this sector Bezeq International is facing new competitors, such as Binat, Taldor, and IBM. In 2010 Bezeq International established its position in the ICT market and gained recognition and accreditation from leading providers in the market.

B. <u>NEP services</u> - The traditional field of telephone exchanges is characterized by a large number of competitors and by fierce competition which has given rise to an erosion of service prices. The most prominent competitors are Tadiran, Eurocom, GlobeCall and Tel-Yad. Data communications and IP telephony (adapting switchboards and terminal equipment to IP technology) is characterized by the entry of new players from the IT world. These are companies such as Binat, Teldor, Malam Tim and IBM. These companies are substantially different from traditional NEP companies and are on a higher technological level. Telecommunication companies are also conglomerating and new operators are entering the market with the intention of providing customers with comprehensive communications solutions which include telephony, transmission, data communications, internet, and information security.

4.8 Seasonality

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

- Voice services for the business sector – decrease in August and during the Passover / Tabernacle holidays.
- Voice services for the private sector – increase in the summer months and towards the end of the Gregorian year.
- Internet services and NEP equipment – increased sales usually achieved in the fourth quarter.
- Internet services for the business sector – a decrease in the summer months owing to the closure of educational institutions (customers in this sector are not billed for the internet services to which they subscribe during the summer vacation).

4.9 Property, plant and equipment

Towards the end of 2004, Bezeq International signed an agreement with Veraz to purchase an international SoftSwitch, which, during the course of 2005, replaced the Alcatel S-12 voice switches (at this stage, these switches are still being used as a non-substantial component in Bezeq International's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an intelligent network (IN), which was also replaced in 2005 and again in 2010 as part of the upgrade of its voice setup.

Bezeq International's technological infrastructures, which support the provision of its voice, data and internet services, are deployed in five sites, inside and outside Israel, to provide services with high redundancy.

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Bezeq International has a long-term lease for the two main structures in which it is based, for average periods of 6 years until 2015.

For details of the agreement for the laying of a submarine cable, see Section 4.12.3.

4.10 Intangible assets

For details of the communication licenses by virtue of which Bezeq International operates, see Section 4.17.2.

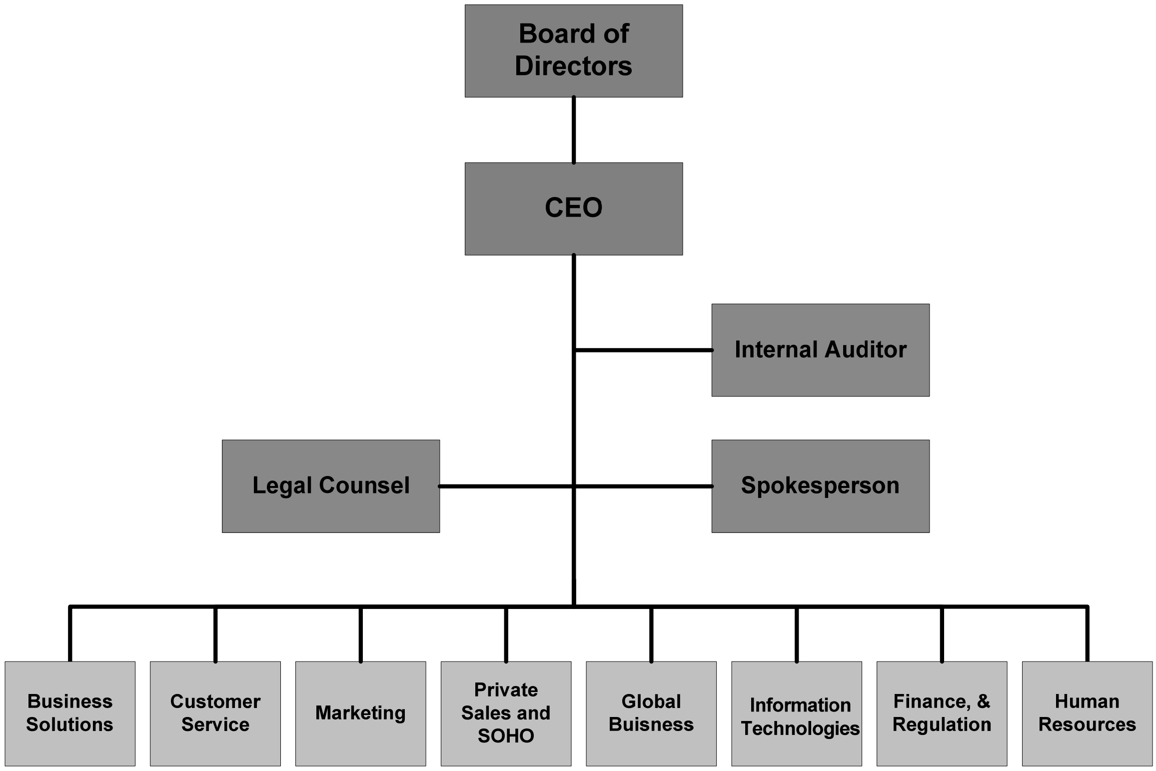
4.11 Human resources

Following are details of the number of persons employed by Bezeq International (employees of the company, outsourced employees in 2009 and 2010:

	Number of employees	
	Dec. 31, 2010	**Dec. 31, 2009**
Head office employees	968	995
Sales and service representatives	1,144	1,450
Total	**2,112**	**2,445**

Organizational structure

Below is a chart depicting the organizational structure of Bezeq Internationa:l.



All Bezeq International employees have standard personal contracts based on their professions and the positions they fill. The salary structure for some of them contains a component of performance-linked commissions and incentives.

A leasing arrangement enables employees to use vehicles at a fixed cost in accordance with the terms of an agreement between Bezeq International and a leasing company. In 2010 Bezeq International began to purchase vehicles which will replace the leased vehicles used by its employees.

Bezeq International invests resources in professional training in accordance with the type of employee and the field in which he or she operates, such as technological training and qualification, manager development courses and more.

4.12 Suppliers

4.12.1 Foreign operators

Bezeq International has cooperation agreements with around 180 foreign operators for 240 destinations worldwide.

4.12.2 Capacity suppliers

Bezeq International is dependent upon the services of the Company which supplies it with domestic capacity an upon the international communications infrastructure provider Mediterranean Nautilus Limited ("Med Nautilus"), which supplies it with most of the international communications infrastructure that it requires through a seabed cable running from Israel to Europe. From there onwards, Bezeq International uses other infrastructure for connecting to the rest of the world.

Under its agreement with Med Nautilus, Bezeq International purchased indefeasible rights of use to an unparticular non-specific part of the communication capacity of the undersea cable system operated by Med Nautilus between Israel and Europe for a period of up to 15 years from the date on which it started using this capacity (with an option to extend the period of use). The periods of use are at least until 2017 – 2027, depending on the date of the start of use of the capacity. Bezeq International paid for these rights of use a non-recurring payment around the date on which it started using the capacity and it makes regular payments for operation and maintenance of the service. Bezeq International is not restricted in the use it makes of the capacity and it may sell its rights, in whole or in part, to third parties. Bezeq International has the option of ceasing its use of the capacity, in whole or in part, at any time, and it will then be exempt from continuing to pay for service operation and maintenance.

Bezeq International is dependent upon the Company and Med Nautilus as infrastructure suppliers.

4.12.3 Agreement for the laying of a submarine cable

Pursuant to approval by Bezeq International's board of directors, on October 31, 2010, and approval by the Company's board of directors on November 1, 2010, at the beginning of November Bezeq International entered into a turnkey agreement with Alcatel-Lucent Submarine Networks for the laying of a submarine optic communication cable between Israel and Italy. At the same time Bezeq International purchased indefeasible rights of use in a continental infrastructure which links its point of presence in Italy to its points of presence in Western Europe.

4.13 Working Capital

4.13.1 Inventory policy

Bezeq International holds inventories for sale and for maintenance, including computer, communications and switchboard equipment. The period for holding inventories derives from the sales and service policy requirements. Based on these requirements, Bezeq International holds stocks according to various categories for periods of 3-4 months on average. The Company's inventory policies aims to hold sufficient inventories for the Company's average requirements as set forth from time to time, with flexibility for unusual cases, based on the nature of the use of the item and its price. Orders from suppliers are placed taking into account past demand and projected forecasts.

4.13.2 Credit Policy

A. Customer credit

1. Most of Bezeq International's customers have credit terms of EOM + 45.
2. Equipment sold to internet customers is usually billed in 24 installments.
3. As part of the NEP services, Bezeq International makes sales to its customers through payments in many installments. In this way, Bezeq International gives its customers credit, which they repay in installments. To reduce the exposure which might derive from long-term credit to its customers, Bezeq International checks their financial resilience, sets ceilings for the maximum credit available to customers and registers a charge over the equipment sold, pending full repayment of the credit.

B. Supplier credit

Bezeq International receives credit from its suppliers for 30 to 120 days (usually 90 days). Below is a table depicting credit for customers and suppliers in 2010:

	Average credit in NIS millions	Average credit in days
Customers(*)	410	97
Suppliers	187	95

(*) Net of doubtful debts

4.14 Investments

4.14.1 Walla Communications Ltd.

See section 1.1.2.

4.14.2 B-Zone Partnership

On October 23, 2006, Bezeq International entered into an agreement with 2Plus Wireless Solutions Ltd. for the establishment of a general partnership called B-Zone (the "Partnership"), to set up, support and manage wireless networks in public areas, enabling connection to the internet and collecting payment from the end-user

4.14.3 Bezecom

On December 21, 2006, Bezeq International signed an agreement with DSNR Communications Ltd. for the establishment of a joint company, under which Bezecom Ltd. was established in January 2007.The purpose of Bezecom is to provide communication services to end-users worldwide, inter alia through a unique communications solution to provide telephony services.

4.15 Financing

4.15.1 General

As of the date of this report, Bezeq International has no liabilities to banks and is not using its approved credit line. The source of Bezeq International's finance in recent years has been a positive cash flow from operating activities.

4.15.2 Bank guarantees

In accordance with the requirements of the Ministry of Communications, Bezeq International provided bank guarantees of NIS 9.4 million and NIS 1.5 million to fulfill all of the conditions of the license for provision of international telecommunications services. As at the balance sheet date, Bezeq International has provided additional bank guarantees in order to meet the contractual commitments it has made in bids for tenders, and legal proceedings, amounting to NIS 16.3 million.

In accordance with the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee in the amount of NIS 10 million to fulfill all of the conditions of the exclusive general license for providing domestic fixed line telecommunication services to B I P Telecom. Solutions Ltd., a subsidiary of Bezeq International.

4.16 Taxation

At December 31, 2010, Bezeq International has carried forward capital losses of NIS 31.1 million.

In addition, Bezeq International has tax assessments that are deemed final through 2005, inclusive.

In December 2010, the income tax authority embarked on a tax assessment and deduction assessment audit for 2006 – 2008 at Bezeq International.

See also Note 9 to the 2010 Financials.

4.17 Restrictions and supervision of Bezeq International's operations

4.17.1 Legislative restrictions

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

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

A recently introduced amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe telecommunications services that do not require a license.

In view of these provisions of the Communications Law, all Bezeq International's telecommunications services are provided by virtue of the provisions of the licenses granted to it and pursuant to the terms therein, as set forth in Section 4.17.2.

4.17.2 Licenses

A. International carrier license[68]

In providing international telephony and data services, Bezeq International is operating in accordance with its international carrier license which is valid until 2022. The provisions of the license stipulate, inter alia, the manner of setting its tariffs for its services, updates and payment collection.

B. Special general Domestic Carrier license

On February 8, 2009 the Minister of Communication granted an exclusive general license for the provisions of domestic telecommunications services to B I P Telecom. Solutions (LP), a subsidiary of Bezeq International, which allows it to provide domestic telephony services via broadband internet access (VoB). On August 2, 2009, Bezeq International started providing these services to private customers and on December 30, 2009 (after the Ministry of Communications determined that the Company's market share in the area of domestic telephony for the business sector had dropped below 85%) this license was amended so as to permit Bezeq International to provide the services to business customers.

C. Special license for the provision of internet access services

On August 10, 2009 Bezeq International received a special license to provide internet access services (ISP). The services Bezeq International is permitted to provide under this license had hitherto been provided under its international carrier license. The provision of an internet license puts Bezeq International on a footing level with that of all the other ISPs who operate under a similar license. The license is valid until August 29, 2014.

D. NEP license

On December 31, 2006 the Ministry of Communications confirmed the transfer of the NEP license from BezeqCall (a Company subsidiary which had engaged in the provision of NEP services) to Bezeq International, following their merger. Since the merger date Bezeq International has provided NEP services by virtue of this license. On April 30, 2010, its NEP license was extended until April 30, 2015.

4.17.3 Interconnect payments

For interconnect fees paid to domestic fix line operators and cellular operators, including the reduction of interconnect fees to cellular operators from 2011, see Section 1.7.3C.

4.17.4 Royalties

Pursuant to its licenses and the royalties regulations, Bezeq International pays royalties to the State of Israel out of most of its revenues from the provision of international call and point-to-point line services and domestic telephony services, net of permitted expenses and excluding revenues from the customers determined in these regulations.

In 2009 the percentage of royalties from its liable revenues (as defined in the regulations) was 1.5%, and Bezeq International paid royalties totaling NIS 3.3 million for that year. In 2010 the percentage of royalties from liable revenues was 1% and Bezeq International paid royalties totaling NIS 2.3 million for that year.

[68] The text of the international carrier license is published on the Ministry of Communications website at www.moc.gov.il .

4.17.5 Standards

Bezeq International holds ISO 9001:2000 certification for quality management systems and ISO 7799 certification for information security management systems issued by the Standards Institution of Israel.

4.17.6 Key regulatory developments

A. Gronau report and amendment of the international carrier license regulations in the matter of the entry of cellular operators into the international calls market

For the Gronau report recommendations and their adoption by the Minister of Communication, see Section 1.7.3A. The adopted recommendations included the following recommendations in respect of the international call sector: (1) The tariff for international calls by a cellular user will be set by the international call company which pays interconnect fees to the cellular operator in accordance with the Interconnect Regulations (see sub-section I below); (2) this change will enable the entry of entities connected to the cellular operators to enter the international call market.

On February 28, 2011 and amendment to the international carrier regulations was published, canceling the limitation concerning "considerable influence" in an international carrier by a cellular operator. Instead of that limitation, the regulations now state that until the date on which a virtual cellular operator (MVNO) starts operation or by the end of 2012, the earlier of the two, the holding of considerable influence by a cellular operator in an international carrier shall be subject to structural separation limitations, including separation of the management and assets of the companies, limitations on hiring shared employees, transfer of commercial information between the companies, and a ban on discrimination in favor of the cellular operator affiliated with the international operator over other licensees.

Bezeq International believes that the entry of the cellular operators into the international call market, particularly if they are permitted to exploit their power as cellular operators in order to strengthen their standing in the international call market, is likely to have a materially adverse effect on the company's market share in this arena. This belief is forward-looking information, based inter alia on the competition structure in the international call market. This belief might well not materialize or materialize partially, depending, inter alia, on regulatory changes in the sector and the scope of the restrictions to be imposed (if any) on the cellular operators if they are permitted to operate in this arena. For more details regarding this matter, see also Partner’s purchase of 012 Smile – section 4.1.7E.

B. Amendment to the licenses of Bezeq International and B.I.P. – sale of service bundles

Concerning the permit granted to the Group companies to market joint service bundles to private market customers, see Section 1.7.2B. In August 2010 the Company began selling joint service bundles which include Bezeq International's internet access services.

For the hearing taking place at the date of this report in connection with the marketing to business customers of joint service bundles of the Company and its subsidiaries, see Section 1.7.2B.

On possible changes following the Hayek Commission, see Section 1.7.3.

C. Hearing in the matter of regulation of the market structure for internet services on a cellular network

In respect of the hearing in connection with the separation between an infrastructure supplier and cellular internet access, see Section 3.7.2C. Bezeq International believes that if this separation is effected, it is likely to have a materially positive effect on Bezeq International's businesses.

D. Change of tariff structure for international calls from a cellular network

On October 31, 2010 the Ministry of Communications decided to adopt the Gronau Commission’s decision and impose on international calls made from Israel on a cellular network the arrangement applicable to international calls made from a fixed line, whereby a consumer dialing abroad from a cellular network is billed only by the international operator which pays the cellular operator for transferring the call, in accordance with the tariff set in the interconnect regulations. The decision further stipulated that the international operator may not increase the price of making an international call to a subscriber dialing from a cellular network over and above the price of a call to the same destination from a fixed-line network, plus the difference between the interconnect charge to a cellular network and the interconnect charge to a fixed-line network. The amendment which is applicable to the international carrier and cellular licenses, took effect on August 1, 2010.

Bezeq International believes that the decision is likely to have an effect on the volume of international dialing services it provides to cellular customers. The decision also constitutes a preliminary condition for the entry of the cellular operators into the international call markets, a procedure which is likely to have a materially adverse effect on Bezeq International's businesses (see sub-section A). On November 1, 2011, the interconnect charges for the cellular operators will decrease (see Section .1.7.3C).

E. Hearing in the matter of providing broadband telephone service to subscribers outside Israel

In March 2010 the Ministry of Communications published a hearing in connection with the provision of broadband telephone service to subscribers outside the borders of Israel (in a manner such that the subscriber can call Israel from abroad using an Israeli subscriber number and for the cost of a local call). A possible decision by the Ministry of Communications in this matter which would allow Bezeq International and other companies to provide the above-mentioned broadband telephone services could have a positive effect on Bezeq International's businesses.

F. Hearing in the matter of regulation of the provision of broadband telephone services by means of cellular data communication services (VoC)

For the hearing in connection with the regulation of VoC services, see Section 2.6.1B. If these services are regulated in the same manner as VoB services, the decision may have a positive effect on the businesses of Bezeq International which could offer the services to its customers.

G. Hearing in the matter of regulation of completion tariffs on calls to overseas cellular destinations

In January 2011 the Ministry of Communications, initiated a hearing in connection with tariffs on calls to mobile destinations outside Israel. In its application the Ministry of Communications proposes alternatives to the regulation of these tariffs.

H. Law memorandum on the exit fee the licensee may demand from a subscriber

See section 1.7.3D.

4.18 Substantial agreements

In the matter of the agreement with Med Nautilus for the purchase of rights of use capacity, see Section 4.12.2. In the matter of the agreement with Alcatel-Lucent Submarine Networks for the laying of a submarine cable, see Section 4.12.3.

4.19 Cooperation agreements

On January 18, 2010 Bezeq International signed an exclusive partnership agreement with British Telecom (BT) for the provision of global communications services to Israeli and multi-national companies operating in Israel. As part of said strategic agreement, Bezeq International will operate as the exclusive partner of BT Alliance in Israel and will market IT services and products from British Telecom's wide range of services.

4.20 Legal Proceedings

Following an adjustment of the Group's materiality bar as of October 1, 2010, this annual statement contains references and/or updates relating to legal proceedings amounting to 5% and more of the

Group's net profit from current operations (approximately NIS 130 million and more[69]) according to the Company's latest consolidated financial statements and also legal proceedings where the amount claimed was not stated in the statement of claim, unless such claim apparently does not meet the above-mentioned quantitative criterion (that is, unless there are additional aspects and/or implications to the proceeding beyond the financial).[70]

Pending proceedings

4.20.1 During the second quarter of 2008, four claims were filed against Bezeq International in the District Courts of the Tel Aviv District and the Central District relating to the use of international calling cards for calls made to the Philippines, Thailand and Nepal and applicable applications for certification as class actions. The plaintiffs, who are foreign workers, claim that the calling cards provide an average of 50% of the calling time indicated to the purchasers of the cards. The plaintiffs also allege that Bezeq International deducts the time spent when unsuccessfully attempting to call someone using the card, that the charging is made contrary to the declaration, not by units of round minutes as indicated, that it is providing misleading information about the number of units on the card and that it formed a cartel with other international operators that raised the prices of calling cards. The plaintiffs seek court permission to file their claim as a class action on behalf of groups of people that include anyone who purchased the relevant calling cards during the seven year period prior to filing the claim or during the proceedings themselves. The plaintiffs estimate that the damages caused to all the members of such groups by Bezeq International is NIS 1,101 million. The plaintiffs also petitioned the Court to order the defendants to cease its conduct as set forth above. The court accepted the application for certification as a class action on the grounds of deception on November 3, 2010. Notwithstanding, the court dismissed some of the grounds for the claimed action and ruled that the existence of deception ceased after the purchase of a number of calling cards. Bezeq International filed an application for leave to appeal to the Supreme Court and an application (which was allowed) for a stay of a decision of certification as a class action until the ruling of the Supreme Court in the matter of leave to appeal.

4.20.2 On May 4, 2009, Bezeq International received a claim, together with a motion to certify it as a class action, which was filed in the Tel Aviv District Court and which deals with raising of the tariffs for internet access services following the first year of operation and charging the plaintiff for services that it claims it did not order. The applicant requests reimbursement of the excess amounts it claims to have paid which amount to NIS 2,800 and for the entire group of customers, for whom the price of the services provided to them was raised after the first year, by NIS 216 million.

4.20.3 On January 24, 2010, Bezeq International received a lawsuit together with a motion to certify it as a class action, which was filed at the Central District Court against Bezeq International and four other communication licensees, with regard to the defendants' obligation to bear the costs of telephone calls to the technical support call centers for their services. The plaintiffs request reimbursement of all the amounts the consumers were charged when they called a support call center and were required to pay for the call to the cellular operator and/or any other entity, and estimated the total amount of the claim against Bezeq International at NIS 105 million. It should be noted that a similar lawsuit was also filed against the Company (in the amount of NIS 23 million) and against DBS (in the amount of NIS 4 million).

4.20.4 On April 13, 2010, Partner Communication Ltd. filed a petition in the HCJ in which it asked the court to order the revocation of Article 11(B)(3) of the Communications (Telecommunications and Broadcasts) (Processes and conditions for obtaining a general special license for the provision of international telecommunications services) Regulations, 2004 which prevents it, as a cellular licensee, or its subsidiary, from obtaining a general license to provide international communication services. In its petition, Partner argues, inter

[69] In order to examine compliance of claim amounts with this criterion the amounts were linked to the CPI. The amounts set forth in this section are the original amounts (excluding linkage differentials) in respect of said criterion, in the event that similar proceedings are initiated against a number of companies in the Group, the claim amount is likely to be examined cumulatively for all the proceedings together.

[70] Accordingly, this report does not contain adjustments regarding the legal proceedings of Bezeq International which have been described in previous Company statements (according to their number in the 2009 Periodic Report) and which do not reach the above-mentioned materiality bar, and are consequently not included in this statement and adjustments will not be included in the Company's statements: 4.19.2 – 4.19.4.

alia, that the decisions of the Minister of Communication in respect of the petition were designed to protect existing international telecommunications service licensees, and for this reason Bezeq International was attached as a respondent to the petition. The entry of Partner into the international telecommunications services market, if the petition is allowed, could have an adverse effect on Bezeq International in this segment. In view of the amendment to the international carrier license regulations (see Section 4.17.6A), the petition is seemingly no long relevant.

4.20.5 On May 24, 2010, Partner Communication Ltd. filed an additional petition in the Supreme Court requesting an order nisi prohibiting the Ministry of Communications from amending the Communication (Telecommunications and Broadcasts) (Payment for interconnect) Regulations, 2000 so as to determine in them that for outgoing international calls from a cellular telephone, a uniform interconnect fee will be set which is the same as the interconnect fee for incoming calls. According to the petitioner, such a decision narrows its license and is harmful to competition. Partner attached to its petition an application for an interlocutory injunction in which it requested that the decision regarding the amendment of the regulations be delayed and not to allow an amendment of the regulations until the petition is heard. Since the decision of the Minister of Communication to amend the regulations is linked to his decision to allow Partner to compete in the international calls market, Bezeq International (and its other competitors in this market) was attached as a respondent to the petition. Bezeq International filed its response to the petition, as did the other parties, following which the court decided that the application for an interlocutory order should be dismissed and the petition should be heard before a bench. At the date of this report, Bezeq International does not appear to be at risk from this petition.

4.20.6 In October 2010, a claim was filed against Bezeq International in the Tel Aviv District Court, together with a motion to certify it as a class action in the amount of NIS 39 million. The claim alleges that Bezeq International does not provide its customers with a written document as required under the Consumer Protection Law, when entering into an agreement for changing or adding to a continuing transaction. Similar claims by other plaintiffs (represented by the same lawyer) were also filed against the Company, Pelephone and DBS – see a more detailed description in section 2.18.10 and also in sections 3.21.1 and 5.20.1C.

Proceedings completed in the period of the report:

4.20.7 Completed proceeding – On September 16, 2001 a renewed statement of claim was filed against Bezeq International and the State of Israel with a motion for certification as a class action, based on the argument that Bezeq International's tariffs for international telecommunications services, in the period between May 10, 1996 and July 8, 1997 were exorbitant and unreasonable and constituted exploitation by Bezeq International of its monopolistic status; this against a background of price cuts upon the opening of the international calls market to competition. On December 25, 2003 the court accepted the motion by virtue of the Antitrust Law and certified it as a class action. In February 2004 the plaintiff filed an appeal in the Supreme Court against the ruling of the District Court regarding the grounds determined in the Unlawful Enrichment Law. In January 2004 the State and the Company filed applications for leave to appeal to the Supreme Court in this matter.

On April 26, 2010 the Supreme Court accepted the appeal of Bezeq International and the State (after it discussed the applications filed for leave to appeal as though they had been granted leave to appeal) and determined that there were no grounds to certify it as a class action.

4.21 Objectives, business strategy and projected development

Bezeq International set itself the goal of continuing to lead the internet services market in Israel for private and business customers, while maintaining its revenues in its traditional markets:

4.21.1 To continue its leadership in the internet access market while continuing to realize the potential inherent in the migration to next generation infrastructure networks.

4.21.2 To intensify and expand its cloud-based services.

4.21.3 To strengthen its status as one of the leading ICT suppliers in Israel.

4.21.4 To increase customer satisfaction by intensifying and expanding customer support services (automated services, social networks, etc.).

These objectives might not be realized or might be realized only partially, due to regulatory changes liable to harm Bezeq International's ability to provide solutions to existing or changing market requirements, and due to all the other risk factors described below.

4.22 Risk Factors

Below is a description of the risk factors stemming from the macro-economic environment, the unique characteristics of the sector in which Bezeq International operates, and risk factors unique to Bezeq International.

4.22.1 <u>Changes in exchange rates</u>

The main currency used by Bezeq International is the New Israeli shekel, which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from customers in Israel. In addition, Bezeq International provides its services to customers all over the world and collects payments from them in foreign currency, mostly the US dollar. On the other hand, Bezeq International consumes services from suppliers outside Israel and pays for these services in foreign currency, mostly the US dollar. The changes in the exchanges rates of the currencies in which Bezeq International operates opposite the Israeli shekel expose the company to exchange rate differences on the gap created, which could have an adverse effect on its cash flow as well as on its profitability by increasing financing expenses. To protect itself against currency exposure, Bezeq International enters into hedging transactions and purchases other financial instruments.

4.22.2 <u>Competition</u>

For the effect of competition on Bezeq International's businesses, see Section 4.7.

4.22.3 <u>Dependence on suppliers</u>

Bezeq International is dependent on its key capacity suppliers – on the Company as its domestic capacity supplier and on Med Nautilus which is currently the only supplier of international communication infrastructure in Israel. Termination of its agreement with Med Nautilus could have a materially adverse effect on Bezeq International's ability to supply a material part of its services. See section 4.12.

4.22.4 <u>Frequent technological changes and investments in infrastructure</u>

Bezeq International's areas of operation are characterized by frequent regulatory changes. The development of technologies constituting attractive alternatives to some of Bezeq International's products (such as Skype) is likely to have a materially adverse effect on its operations.

Furthermore, the technological developments require frequent investments in infrastructure. See section 4.12.

4.22.5 <u>Government supervision and regulation</u>

For the application of the provisions of the law and licensing policy and their effect on Bezeq International, see Section 4.17. Changes in regulation applicable to Bezeq International could have an adverse effect on its results and operations.

4.22.6 <u>Legal proceedings</u>

Bezeq International is a party to legal proceedings, including class actions, some of which could result in its being required to pay substantial sums. A provision has been made in the financial statements of Bezeq International and the Company for those proceedings which, according to the assessment of the company's legal counsel, could require the use of Bezeq International's financial resources. For legal proceedings to which Bezeq International is a party, see Section 4.20.

4.22.7 Failure of Bezeq International's systems

In the event of damage to part or all of the systems used by Bezeq International to provide its services, whether because of all kinds of technical failures or whether because of natural disasters, significant difficulties could be caused to the provision of its services.

Below is a table illustrating the effects of the above risk factors on the operations of Bezeq International, as assessed by its management. It should be noted that these assessments of the extent of the effect of a risk factor reflect the extent of its effect based on the assumption that it becomes reality and nothing in the aforesaid expresses an assessment or gives weight to the chances of such an event. The order in which the risk factors appear above and below does not necessarily accord with the rating of the risk:

	Effect of risk factor on Bezeq International's operation		
	Major	**Moderate**	**Minor**
Macro risks			
Exposure to changes in the currency exchange rate			X
Sector risks			
Increasing competition		X	
Investments in infrastructure and technological changes		X	
Government supervision and regulation	X		
Special risks for Bezeq International			
Exposure in legal proceedings		X	
Dependence on suppliers			X
Systems failure		X	

The information contained in section 4.22 and the assessments of Bezeq International regarding the effect of the risk factors on its operations and businesses is forward-looking information as defined in the Securities Law. The information and assessments rely on data published by the Ministry of Communications, assessments of Bezeq International regarding the market situation and the structure of competition in it, and possible developments in the market and in the Israeli economy. Actual results may differ materially from these assessments if there is a change in any of the factors taken into account in making them.

5. DBS – Multi-channel television

5.1 General Information on the segment of operation

DBS, also known also by its trade name YES, provides multi-channel satellite broadcast services to subscribers. DBS was founded on December 2, 1998, and has been providing this service since July 2000.

DBS provides its services by means of an engineering setup which includes terrestrial broadcasting centers transmitting content to the satellites which is received by antenna dishes and domestic decoders in accordance with the broadcast package purchased by the subscriber.

Most of DBS's income derives from subscription fees and additional payments made by its subscribers.

At December 31, 2010 DBS had 577,700 subscribers.

DBS is the only company in Israel currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure of area of operations and changes therein

A. The area of broadcasts is characterized by comprehensive regulation, including, inter alia, the obligation to obtain a license, the obligation to operate in accordance with the relevant provisions of the Communications Law, and ongoing supervision of the Ministry of Communications and the Council for Cable TV and Satellite Broadcasting (the **"Council"**).

B. Multi-channel television broadcasting in Israel is provided, in addition to DBS, by HOT which provides cable television services. HOT has a monopoly declared under the Antitrust Law in the area of multi-channel television broadcasting. HOT Telecom, a fully-controlled subsidiary of HOT, has a cable network infrastructure, including terminal equipment and broadcasting centers and it provides internet infrastructure services as well as fixed-line telephone services. For its license to provide internet access services (ISP) which was granted to HOT-Net of the Hot group in 2010, see Section 1.7.1.

C. A terrestrial distribution system for digital radio broadcasts began operations in August 2009 (see Section 5.1.3A). Consumption of video content broadcast via the internet also increased (se Section 5.1.5A)..

5.1.2 Statutory restrictions and special constraints

A. The Communications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license. The license is valid until January 2017 and at the end of this period it will be renewable for additional periods of six years each, subject to the conditions of the license. For additional licenses granted to DBS, see Section 5.10.1.

B. In addition to the licensing required for broadcasting operations, operations in this area and in other areas of communication are subject to licensing, supervision and the policy decisions of the Ministry of Communications with regard to aspects defined in the law and the communications licenses (which relate mainly to matters regarding competition, consumers, and technical and engineering aspects). As a result of the coherence and overlap between broadcasting and other areas of communications, and the operations of HOT and related telephony and internet entities, broadcasting is materially influenced by the policy and supervision of the Ministry of Communications in various additional areas.

C. The broadcasting operations of DBS and HOT are also under the ongoing supervision of the Council. The Council sets policy and makes rules and has supervisory authority regarding the content of broadcasts, the duty regarding original Israeli productions, broadcasting ethics, consumer protection and approval of the channels broadcast. The Council is also authorized to amend the broadcasting licenses of DBS and HOT.

5.1.3 Changes in the scope of operations and profitability in the sector

For details of changes in the scope of DBS's area of operations and its profitability, see Section 1.5.4D.

5.1.4 Market developments in the segment of operation

In recent years, a number of trends which affect competition have emerged in the broadcasting industry:

A. Since August 2009, the Second Television and Radio Authority (the **"Second Authority"**) has been operating a terrestrial digital radio broadcasting system which freely broadcasts the television channels of the broadcasting authority (Channel 1 and Channel 33), commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) to the nation. This setup constitutes a partial alternative product to the broadcasts of DBS and DBS believes that a material increase in the number of its users is liable to cause material harm to its revenues.

   In February 2011 the government decided, further to an investigation of the Ministry of Communications and the Ministry of Finance, together with the Second Authority and the Council, to formulate legislative amendments which would anchor the expansion of the DTT setup, in two stages, within 24 months from the entry into force of these legislative amendments. Pursuant to the decision, and subject to the terms and the terms to be determined in the legislation, a radio channel containing regional and national radio channels, an "Educational 23" channel, the designated Russian-language channel, the designated Israeli music and Mediterranean music channel, an additional channel of the broadcasting authority which will broadcast using HD technology, a designated Arabic channel, a designated news channel and a dedicated heritage channel will be added to the setup in two stages. Any of the above channels may be added upon request with payment of a distribution charge. In accordance with the decision, the Minister of Communications may, in consultation with the Minister of Finance, the Council and the Second Authority, add more channels to the setup in accordance with applications from the channels and the regulations which will be determined in this matter. The government also decided that in January 2014, the ownership and operation of the DTT setup would be transferred from the Second Authority to another government or public body which does not supervise television broadcasts. An increase or variation in the number of channels to be distributed via this setup is likely, in the opinion of DBS, to increase the capability of the setup to offer substitutes for DBS's services and this is liable to cause material harm to its revenues.

B. In May 2009 the government decided to amend the Communication Law so that it would include, inter alia the following legislative arrangements:

   1. Commencing August 1, 2012, DBS and HOT will be obligated to allow any subscriber to connect to a package including Channel 1, Channel 33, Channel 2, Channel 10 and the Knesset Channel (in this paragraph - the **"Basic Package"**) subject to restrictions, inter alia, on the payments they are allowed to collect for connecting a subscriber to the Basic Package and for the transfer fee to be paid by the owners of the channels included in the Basic Package. In addition, they will not be allowed to make the purchase of one broadcast conditional upon the purchase of another broadcast, where the determination of a tariff for the purchase of a number of broadcasts shall not be conditional as aforesaid;

   2. DBS and HOT will be authorized to broadcast commercials from January 1, 2012, and the Council will set rules in respect of maximum broadcast time for the various types of channels for a period of three years, which will enable the gradual broadcast of commercials.

   3. The broadcasting licensees will transmit to all their subscribers broadcasts from the holder of a special cable broadcasting license without collecting payment from subscribers beyond the access fees.

      In addition, the government decision adopted recommendations submitted to it by a committee regarding the transfer of the Second Authority franchisees to licensees.

In May 2010 the government withdrew a draft bill which was supposed to anchor in legislation, inter alia, the above arrangements, while instituting a separate legislative proceeding to regulate the transfer of Second Authority franchisees to licensees. To the best of DBS's knowledge, the issue of the Basic Package is still under consideration by the government.

In February 2011 an amendment was enacted to the Second Authority Law most of which deals with a change in the method of regulating commercial broadcasts, while transferring from the system of granting franchises to a system of granting licenses for commercial television broadcasts to anyone complying with the threshold terms without a tender proceeding (a "Commercial Licensee"), and includes, inter alia, the following arrangements: the date of transfer between the systems is scheduled to be January 1, 2013; each Commercial Licensee may be included in the DTT broadcasting setup; the Minister of Communication, after consultation with the Council and the Second Authority, may determine a list of five sequential channels designated for the transfer of broadcasts of a Commercial Licensee by DBS and HOT (the "Channels"); the Minister of Communication may order that for three years from the date on which no franchisee for television broadcasts on Channel 2 or Channel 10 remains, there will be no broadcasts of any channel on Channels 10 or 22; a mechanism is determined whereby the moneys received from the Commercial Licensees for the use of the Channels will be used to produce original productions which will be broadcast by DBS and HOT and in the broadcasts of franchisees and/or Commercial Licensees, in accordance with a distribution to be determined.

After holding a consultation proceeding, the Minister of Communications announced on February 28, 2011 that the channels designated for the broadcasts of Commercial Licensees by DBS and HOT will be Channels 12 to 16.

5.1.5 Technological changes that can materially impact the segment of operation

The increase in the bandwidths of communication infrastructures in Israel, alongside technological improvements enabling the transmission of video content via the internet, cellular networks and additional infrastructures, and compression capabilities enable wider use of these infrastructures for the transmission of video content. This change will lead to material developments:

A. Transmission of video content on communication infrastructures – this development has led to an increase in the number and range of video content accessible to the public (whether with or without authorization from the holders of title to the content) via the various communication infrastructures[71], where viewing the content is by means of various items of terminal equipment, among them PCs, television

The development of this trend enables the supply of various forms of video content without the need to set up a designated infrastructure system, and it could have a materially adverse effect on the broadcasting sector, which is currently based on designated infrastructures. This effect could be aggravated if his supply of content continues to be unregulated.

B. DBS's launch of VOD over the internet – this change allows DBS to launch VOD (Video on Demand) services provided over the internet (see Section 0).

For the committee examining the regulation of the transmission of content on new broadcasting platforms and technologies, see Section 5.4.

5.1.6 Critical success factors in the segment of operations and changes occurring in it

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

A. Quality, differentiation, innovation and originality in the content, variety, branding and packaging of its broadcasts.

[71] For the option of setting up an additional communication infrastructure on the network of Israel Electric Corporation, see Section 2.6.4C.

B. Provision of television services while using advanced technologies such as personal television services, and in particular, VOD services and PVR and HDPVR machines. (See section 5.7.5D).

C. Offers of bundles of communications services including television services and other services such as telephony services and internet services (see Section 5.7.3).

D. High level of customer service.

E. Brand strength and its identification with quality, innovation and industry-leading content and services.

5.1.7 <u>Main entry and exit barriers for the segment of operation</u>

A. The main entry barriers into the segment are these: (a) the need for licenses under the Communications Law; (b) the investments required of carriers in the area of operations, including for the purpose of setting up an appropriate infrastructure and purchasing and producing content; (c) the limited size of the broadcasting market which reduces the size advantage characteristic of the broadcasting field around the world; (d) saturation of the broadcasting market.

B. Recently, some of these entry barriers have started to crumble as a result of regulatory changes (such as DTT) and as a result of technological developments enabling the transfer of content over communication infrastructures (see Section 5.1.5A).

C. The principal exit barriers are: (a) the regulatory barrier – termination of operations under the Broadcasting License depends on a decision of the Minister of Communications to cancel the license prior to the end of the license term, under the conditions set out in the license, including arrangements (which could be imposed on the licensee) for ensuring the continuation of broadcasts and services and minimization of harm to subscribers. (b) long-term contracts with important suppliers, entities which granted DBS long-term loans and subscribers.

5.1.8 <u>Substitutes for and changes in products in the sector</u>

In respect of multi-channel television broadcasts, DBS regards the following principal services as alternatives to it products:

A. The variety of terrestrial channels broadcast to the Israeli public free of charge. For the DTT setup, see Section 5.1.3.A. In addition, many foreign channels may be received in Israel using relatively inexpensive terminal equipment.

B. Access to video content via various infrastructures, including the internet and cellular networks (see Section 5.1.5A).

5.1.9 <u>Competition structure and changes occurring in it</u>

The penetration rates of DBS and HOT are very high and are estimated by DBS at approximately 70% of households in Israel. DBS believes that its chances of penetrating an additional material segment are not high for the reason that most of the remaining households are not potential customers for DBS and HOT. To the best of DBS's knowledge, in recent years there has been a decrease in the total number of subscribers of DBS and HOT, with a moderate increase in DBS's share of this market. The strengthening of alternative products is also liable to result in a decline in the above-mentioned penetration rate. Consequently, an increase in the number of subscribers may be accomplished mainly by recruiting subscribers from the competition and recruiting new subscribers following the natural growth in the number of households. This means that the broadcasting sector is characterized by fierce competition between HOT and DBS, which requires an investment of substantial resources to retain existing subscribers and recruit new ones.

For further details of competition in the segment, see Section 5.7.

5.2 Products and Services

DBS's broadcasts include a wide variety of channels: there are approximately 150 different video channels (of which 20 are pay per view (PPV) channels and 10 are HD (High Definition) channels) and 20 radio channels, 30 music channels and interactive services.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as single and PPV channels. The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package, the sports package and the science and nature package.

For VOD services marketed by DBS see Section 5.4.

DBS markets PVR decoders which interface with DBS's electronic broadcasting schedule and enable receipt of special services, including ordering recordings in advance, recording series and pausing live broadcasts. The PVR Decoders also enable viewing of the content which is transferred from time to time to the decoder's memory stored in the decoder's memory which is updated from time to time by DBS (push video).

DBS also provides its subscribers with HD broadcasts which can be received through special decoders. These broadcasts which at the date of this report are provided for a limited number of channels, allow superior quality viewing. DBS also markets HDPVR decoders.

In 2010 DBS achieved a significant increase in the number of its subscribers using PVR decoders while at the end of 2010, 47% of the total number of its subscribers were using PVR decoders, compared with 37% at the end of 2009.

DBS believes that an increase in the number of subscribers using PVR decoders contributes to an increase in its revenues from these subscribers and to their retention as subscribers, but it requires a material financial investment.

DBS has a content website which is operated together with Walla which allows viewing of various forms of content, some of them at a fee.

5.3 Revenue and profitability of products and services

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

	2010	2009
Revenues from broadcasts and multi-channel television services to subscribers	1,583	1,530
Percentage out of revenue	Approx. 98%	Approx. 98%

5.4 New Products

VOD services – at the end of 2009 DBS began trialing VOD services via the internet (the unmanaged network). This method has limitations with regard to the types of decoders enabling service reception (in the preliminary stage this service will be offered only to owners of HDPVR Decoders and only at a later stage to owners of other decoders), and with regard to availability of services owing to restrictions on the internet infrastructure and bandwidth installed in customer homes. DBS launched this service on March 2, 2010.

DBS believes that VOD services are not subject to the regulation currently applicable to multi-channel television broadcasts and to the best of its knowledge this is the position of the Ministry of Communications. Nevertheless, at the date of this report, a professional team working jointly with the Ministry of Communications and the Council is examining the issue of regulation of broadcasts on new platforms and using new technologies, the scope of the regulation and the effect such regulation will have on the current regulation. The conclusions of this team which have not yet been published, could have implications for the regulation of the VOD services provided by DBS.

5.5 Customers

The overwhelming majority of DBS's subscribers are private customers. DBS's subscriber agreements regulate the rights and obligations of subscribers in their relations with DBS, including the types of services offered and the payments which DBS may collect, and the various provisions relating to terminal equipment and its maintenance. Pursuant to the provisions of the broadcasting license, the text of the subscriber agreement requires approval from the Council and from the Standard Contracts Tribunal. The subscriber agreement has been approved by the Council and also by the Standard Contracts Tribunal. At the date of this report, the validity of the approval granted by the Standard Contracts Tribunal has expired. The Council has approved a number of amendments to the subscriber agreement and DBS is working to obtain its approval of the other amendments, after which the amended subscriber agreement will be resubmitted for approval to the Standard Contracts Tribunal.

The company's supply of broadcasts and services and their prices appear in its price list. Most subscribers sign up for offers where DBS's services, including various constituents of the content bundles, accompanying services and terminal equipment and its installation, are provided at prices lower than those of the price list relating to the package constituents. In most of DBS's offers, subscribers are required to commit to an agreement period (for restrictions on the commitment period, see Section 5.17.8).

5.6 Marketing and Distribution

5.6.1 Marketing of DBS services is by way of publication in the various media. DBS's sales operations are carried out via three main distribution channels:

A. Sales people, who are DBS employees, working to recruit subscribers.

B. Call centers operated by DBS employees, that receive telephone enquiries from customers wishing to receive DBS services, as well as telemarketing campaigns to potential subscribers.

C. External resellers. DBS is somewhat dependent on external resellers who recruit approximately fifty percent of the subscribers recruited by all external resellers and a significant proportion of their work focuses on the recruitment of a particular target population.

5.6.2 DBS's sales operation relating to existing subscribers is effected through the use of call centers, some of which are operated by its employees, and some by third parties.

5.7 Competition

5.7.1 Competitors in the broadcasting market

The subscriber multi-channel television market in Israel is estimated at approximately 70% of all homes in Israel.

DBS's principal direct competitor, as mentioned in section 5.1.1 above, is HOT, which is also provides multi-channel television services to subscribers. DBS also regards the DTT setup as a competitor for its services (see Section 5.1.3A).

To the best of DBS's knowledge, in recent years there has been a decrease in the total number of subscribers of DBS and HOT, with a moderate increase in DBS's share of the multi-channel television market. Below are data relating to changes in DBS's subscriber numbers and market shares, to the best of its knowledge, at December 31, from 2008 – 2010.

2010		2009		2008	
Subscribers*	Market share	Subscribers*	Market share	Subscribers*	Market share
577,700	39%	570,000	38%	559,613	38%

* Approximate numbers. Subscriber – one household or one small business customer. In the event of a business customer with many reception points or a large number of decoders (such as a hotel, kibbutz or gym), the number of subscribers is calculated by dividing the total payment received from the business customer by the average revenue from a small business customer.

5.7.2 Broadcasting characteristics of the competitors

DBS transmits its broadcasts using a digital broadcasting method only, whereas HOT broadcasts to most of its subscribers using a digital broadcasting method, while for the remainder it uses an analog broadcasting method which allows for lower-quality viewing, does not enable display of an electronic program guide and requires the purchase of a uniform channel package without the option of choosing broadcasting segments (for further implications of this difference, see Section 5.7.4). To the best of DBS's knowledge HOT is working to reduce the number of its subscribers connected to the analog system.

For the characteristics of DTT broadcasting, see Section 5.1.4A.

5.7.3 Characteristics of competition today

At the date of this report, competition in the broadcasting arena focuses on content, packages and channels, on service and on offering additional services such as VOD services, PVR decoders, HDPVR decoders and HD broadcasts. In recent years there has been a discernible trend toward demand and supply of personal television services which allow the customer to choose which content to view and when to view it (in contrast to viewing linear channels where the content broadcasting sequence is determined by the broadcasting entity). This trend is supported by the expansion of PVR services, VOD services and other services.

Competition is also characterized by the additional communication services offered by HOT as part of its “service bundle” (see Section 1.7.1). In light of the license to supply internet access services, which to the best of DBS's knowledge was granted to HOT-Net of the HOT group, HOT will also be able to include this service in its service bundle.

Pursuant to the amendment to the broadcasting license of June 2010, DBS is authorized to offer a service bundling the Company's service with DBS's service, subject to receipt of approval from the Ministry of Communications (which in the absence of opposition within the period stipulated in the license will be considered to have been granted) and also subject to conditions, the principal ones being the unbundling obligation and the existence of a parallel bundle marketed by a licensee which is not linked to the company (see Section 1.7.2). A service bundle containing only the Company's internet infrastructure service does not require approval from the Ministry of Communications and is not subject to the unbundling obligation.

For cooperation between the Company and DBS in the matter of marketing the joint service bundle, see Section 5.19.

DBS believes that marketing a service bundle with the restrictions stipulated in the amendment to the above license will constitute a partially competitive response to the service bundle offered at the date of this report by HOT. This belief of DBS is forward-looking information as defined in the Securities Law, based on its assessment of the service bundle which it will offer and the application of the restrictions to this bundle. If service bundles are launched or permitted to be launched in different formats, including because of regulatory restrictions, or there are changes in HOT’s service bundle, this assessment could change.

5.7.4 Positives and negatives in competition

A. DBS's management estimates that DBS has competitive advantages, the principal ones being:

1. Use of some of the most advanced digital technology in the world in order to transmit its broadcasts.
2. Option of receiving broadcasts even in remote or isolated areas where there is no access to a cable infrastructure.
3. Quality and variety of content broadcast by DBS to its subscribers.
4. Level, quality and availability of DBS’s customer service, both telephone service and technical service.

B. However, DBS’s competitive operations suffer from inferiority or from adverse factors in a number of areas, the main ones being:

1. Inferiority of infrastructure – DBS's infrastructure is inferior because it does not enable bidirectional communication, it does not enable the provision of VOD services and does not enable the transmission of telephony and internet services,

in contrast to the infrastructure of HOT which enables the supply of these services.

2. Regulatory restrictions:

As mentioned in section 5.7.3, DBS and the Company are subject to regulatory restrictions which limit DBS's option of offering a service bundle containing DBS's services bundled with those of the Company at competitive prices. DBS is also subject in light of the Company's holdings in it, to a restriction on obtaining a license which would allow it to provide telephony services itself over broadband internet (VoB). As long as these restrictions remain in place, and as long as the HOT Group is not subject to similar restrictions, they harm DBS's ability to offer service bundles at competitive prices.

Furthermore, DBS is subject to restrictions on its broadcasting content, one of which is a ban on broadcasting commercials (see Section 5.17.7) and restrictions on the ownership of the channels it broadcasts, including the News Channel (see Section 5.17.9). These restrictions are also applicable to HOT.

3. Space segments - DBS has significant expenses involved in the use of space segments which are necessary for the purpose of providing DBS's broadcasts. There is also a restriction on its ability to expand supply of its broadcasts which depends on availability of additional space segments or an improvement in compression capability which entails a financial investment (see Section 5.8).

4. Transmission of video content via additional communication infrastructures - DBS views the capacity to transmit video content via additional communication infrastructures including the internet and cellular networks, as a factor that might adversely affect its competitive standing in the broadcasting field, including as a result of the entry of additional competitors into the field of multi-channel broadcasts (see Section 5.1.4A).

5. HOT has a much greater degree of accessibility to customers of its analog system who wish to receive digital television services. The analog broadcasting method allows its subscribers to receive broadcasts at a relatively lower cost because it stems from the option of receiving broadcasts without using a digital decoder.

5.7.5 <u>Principal methods for coping with competition</u>

Following are the main methods used by DBS to deal with competition in the field of broadcasting:

A. Content – DBS acts to purchase, produce and broadcast high-quality, innovative and varied content, creating differentiation of its content;

B. Branding – cultivation, promotion and differentiation of the YES brand;

C. Service – DBS places an emphasis on its customer service and technical service systems;

D. Technology – DBS makes investments in order to expand its technological capabilities, while placing an emphasis on technological innovation. To achieve this goal, it attaches great importance to the supply of personal television broadcasts as part of the range of services it offers its subscribers, including VOD, PVR and HD services.

5.8 Production capacity

The number of channels which DBS is capable of broadcasting to its subscribers depends on the number of space segments it is using, its compression capability and the bandwidth required for the transmission of all types of channels. At the date of this report, DBS uses all the space segments at its disposal and so an increase in the number of channels it broadcasts, particularly an increase in the number of HD channels it broadcasts (which require greater bandwidth) would require additional space segments or an improvement in the compression systems it uses. DBS leases space segments from a third party (see Section 5.18.1).

In addition, in matters arising from the provision of advanced content services to subscribers, including VOD and HD content, an increase in the penetration rates of these services depends on the supply of additional PVR/HDPVR decoders.

5.9 Property, plant and equipment

Below are the principal components of DBS's property, plant and equipment:

5.9.1 Land

DBS leases a number of real estate assets which serve as its offices, broadcasting center, logistics center and employee recruitment centers. Its principal offices and its central broadcasting center are located on leased land in Kfar Saba. The lease periods for these sites expire in 2019, while the balance of the lease periods for the remaining properties leased by DBS varies from a few months to approximately 9 years (these periods are based on the assumption that DBS will exert its extension options for these leases).

5.9.2 Terminal equipment

DBS installs a receiver dish and other terminal equipment in subscriber homes, among them, decoders used as a receiving and decoding unit for the reception signals, which constitute an interface with the subscriber's television screen as well as smart cards used to decode the encrypted broadcasts. Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers. DBS capitalizes the installation costs for the terminal equipment as part of its property, plant and equipment

At the date of this report the agreement by virtue of which DBS purchases decoders (including PVR decoders) is a framework agreement from August 2000, as amended from time to time, between it and Advanced Digital Broadcast S.A. (**"ADB"**) and Eurocom Digital Communication Ltd. (**"Eurocom Digital Communication"**) which is controlled (indirectly) by Mr Shaul Elovitch, a controlling shareholder of the Company, who is also a controlling shareholder (indirectly) of Eurocom DBS, the largest shareholder in DBS[72] (**the "ADB Agreement"**). Under the ADB Agreement decoders are purchased from Eurocom Digital Communication which imports them from ADB and provides the warranty for the decoders which ADB undertook to issue under the agreement. Eurocom DBS also provides a repair service for the decoders for repairs which are not included in the warranty.

In 2010 DBS purchased from Eurocom Digital Communication HDPVR decoders in the total amount of NIS 104 million. DBS is dependent on ADB and Eurocom Digital Communication for the purchase of HDPVR decoders. Replacing the supplier with another supplier does not in itself entail material cost but it would require a significant preparation period for adaptation of the replacement supplier's decoders to DBS broadcasting and encryption systems which could cause DBS loss of revenues. Maintenance of decoders purchased from a particular supplier which is not carried out through the same supplier could entail additional costs and maintenance problems.

5.9.3 Broadcasting equipment and computer and communications equipment

DBS has its central broadcasting center in Kfar Saba and a secondary broadcasting center close to Re'em Junction from where it transmits its broadcasts. Its broadcasting centers contain reception and transmission equipment and DBS's property, plant and equipment which also include computer and communication systems. The secondary broadcasting center is operated by a third party which makes available to DBS its services for operating and maintaining the secondary broadcasting center in accordance with an agreement which is valid until the end of 2013 (with an extension option available to DBS).

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[72] For details of the share trust of Eurocom DBS by virtue of the terms of the merger determined by the Antitrust Commissioner, see Section 1.1.2.

5.9.4 Operating and encryption systems

DBS purchases services for the operating systems of its broadcasting and encryption setup from NDS Ltd. (**"NDS"**) as well as hardware for these services. DBS is dependent on the regular supply of these services and products, including integration in connection with the types of the various decoders which it uses for the operating systems for which NDS provides services.

Under the terms of the agreement with NDS, NDS supplies development, licensing, supply, training, assimilation and maintenance services for encryption, broadcasting and ancillary software and equipment required for the broadcasting system. NDS has undertaken to adapt the equipment and services it supplies to the various decoders and systems purchased by DBS and also to supply a warranty for its products and also support services. DBS has also entered into agreements with NDS for the purchase of services enabling the provision of PVR, HD and VOD services. DBS makes one-off payments and periodic payments for the services and products of NDS. These payments are based primarily on the number of decoders it uses and the number of its active subscribers. The agreement with NDS expires at the end of December 2013.

5.10 Intangible assets

5.10.1 Licenses

DBS owns the following main licenses:

A. Broadcasting license valid through January 2017 – this license is material to DBS's operations and is the main regulatory permit for its operations (for the conditions of this license, see section 5.17 below).

B. License for satellite television broadcasts in the Judea and Samaria region valid through 2016, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judea and Samaria region.

C. License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and performance of setup and ancillary operation activities), which is valid through January 2017 or until the end of DBS's broadcasting license, the earlier of the two. This license is material to DBS's operations and is the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

D. License for the provision of uplink/downlink services to other communication licensees, which is valid through October 2013. At the date of publication of this report, DBS does not use this license.

5.10.2 Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services. The main DBS registered trademarks relate to the protection of its trade name (**yes**), its key content channel names, the names of some of the channel packages it markets and of its unique terminal equipment.

5.10.3 Software and licenses

See Note 8 to DBS's 2010 financial statements.

5.11 Broadcasting rights

5.11.1 DBS has the broadcasting rights of video content purchased from the owners of intellectual property rights in such content.

The broadcasting of content with respect to which DBS owns broadcasting rights involves the payment of royalties to the owners of copyrights of musical works, voice records, scripts and content direction, including under the Copyright Law, 2007 and the Performers and Broadcasters Rights Law, 1984. Payment of royalties, as aforementioned, is done via a number of organizations that operate in Israel which collect the royalties for the owners of the intellectual property rights and in return provide the broadcasting entities with blanket licenses. Payments by DBS under these licenses are, at times, based on a fixed payment and at other times on various pricing methods, including those that depend on a change in the number of subscribers, as aforementioned.

DBS and one of said organizations, the Association of Composers, Authors and Publishers of Music in Israel ("ACUM") have agreements, according to which the royalties paid to ACUM as of 2003 are advances on account of the royalties, at a rate derived from what HOT pays ACUM and that these amounts will be paid until a different agreement is reached with ACUM, *inter alia*, considering the agreement reached, if reached, between HOT and ACUM with respect to the royalties to be paid to ACUM.

Pursuant to an immediate report published by HOT, in July 2010 a judgment was entered in arbitration between HOT and ACUM regarding the mechanism defined for calculation of the annual royalties in respect of use of works, the rights of which are protected by ACUM. According to this report, the arbitration judgment accepted, in principle, the outline of the royalty calculation model as presented by ACUM in that proceeding, with the exception of certain changes, and determined that this model would also apply to the difference in royalties from 2003 forward, according to a calculation to be performed by the parties to arbitration in a mutually agreeable manner. In November 2010, HOT announced that it disputed the arbitration judgment and filed an appeal of the arbitration judgment. Since DBS does not have the arbitrator's judgment, arbitration documents and appeal documents, DBS does not know which model was adopted by the arbitrator and the reasoning behind the judgment.

According to ACUM, and this is disputed by DBS, the differences in the royalties to be charged to DBS in respect of 2003 forward, will also be determined in accordance with the decision of the arbitrator. Consequently, DBS management believes that after the arbitration judgment, if not overturned, ACUM will require DBS to pay differences in material amounts, retroactively, and even to pay royalty payments in the future that are significantly higher than what has been paid to date. In light of the above, DBS revised its estimate of the amount of royalties since 2003. The revision of the royalties estimate was performed according to the outline of the royalty calculation model received from ACUM shortly after the arbitration judgment was entered, while performing the adjustments in accordance with the estimates of DBS management. This then served as the bases for the material provisions DBS set aside in its financial statements.

With respect to other copyright organizations, it was agreed with some that payment of royalties would be made for television broadcasts during the term of the engagement with them (expected to expire in 2011 and 2012). With respect to the other organizations, the undisputed amount of royalties is paid, and DBS may be required to pay additional amounts as royalties. DBS does not believe that the amounts it may be required to pay, whether in respect of television broadcasts (following resolution of said disputes) or the transfer of content over other media, will be material. This estimate by DBS is a forward-looking statement, based among other things on estimates by DBS, including regarding the amount of use of the content and the positions of the various organizations, and should any of them change, this estimate may change accordingly.

5.11.2 DBS participates, fully or partially, in investment in original productions it broadcasts. In consideration for its investment, DBS is usually entitled, in addition to the right to broadcast the content as part of its transmissions, to rights in such content, in the percentages set out in agreements with the producers. Sometimes, DBS is also entitled to grant authorizations to use rights and to participate in revenues attributable to additional uses of content beyond their broadcast by DBS.

5.11.3 Additionally, DBS enters into agreements to receive licenses to broadcast local and foreign channels, in consideration of a fixed annual payment or payment dependent on the number of subscribers to the relevant channel.

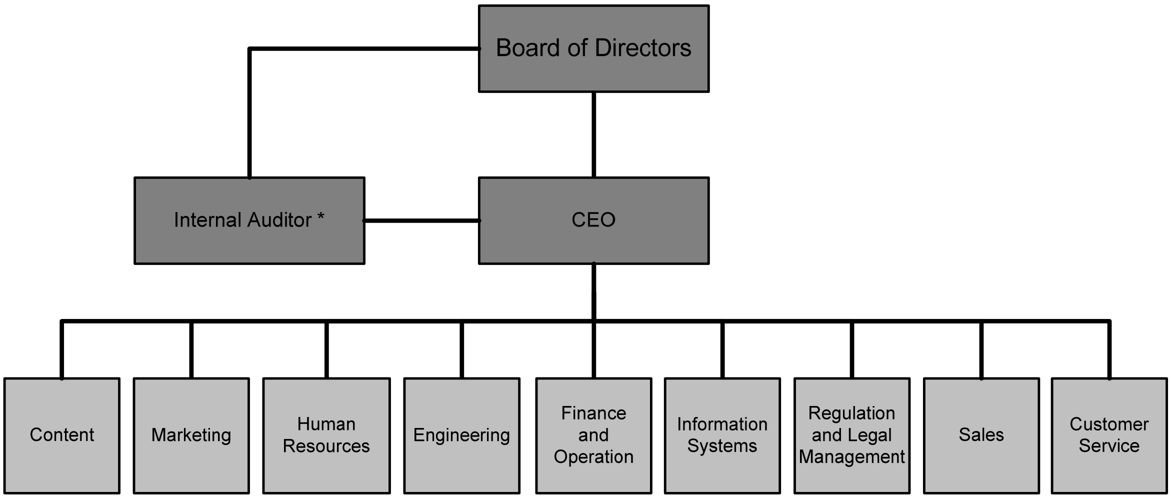
5.11.4 Given the many content providers from which DBS purchases broadcasting rights, DBS does not have a main content provider and is not materially dependent on any single content provider. However, with respect to broadcasts of Israeli sports, at the date of this report there is dependence on the purchase of the broadcasting rights of local sports channels by these two content providers.

5.11.5 For information regarding the presentation of the broadcasting rights in DBS books and the amortization of their costs, see Notes 3B and 9 to the DBS 2010 Financials.

5.12 Human Resources

5.12.1 Organizational structure

DBS has nine departments, each headed by a VP, who are members of DBS management, as shown in the figure below:



(*) The Internal Auditor is not an employee of DBS.

5.12.2 DBS personnel by department

Department	Number of Employees	
	At December 31, 2009	**At December 31, 2010**
Marketing Department	31	35
Customer Service	1,705	1,752
Content Department	72	78
Engineering Department	92	97
Finance and Operations Department	117	115
Human Resources Department	43	48
Regulation and Legal Management Department	3	3
Information Systems Department	88	94
Management and Spokesperson	7	7
Total	2,158	2,229

At the beginning of 2011, sales was spun off from Customer Service into an independent department.

5.12.3 Training and human resources development

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

DBS trains its employees on an ongoing basis and also carries out manager training and support on an ongoing basis.

5.12.4 Employee compensation schemes

A. In September 2008, 4,250,000 Company option warrants were allocated to the CEO of DBS. They are exercisable into Company shares at the exercise price of NIS 5.24 per option warrant on the allocation date (as will be adjusted according to the Company's payment of dividends as of allocation date). The fair value of the option warrants on the allocation date was NIS 10,280,000. The option warrants vest in three equal annual portions, and by the date of this report, two of the three portions have vested. With respect to the third portion, the Company informed the CEO of DBS that it is reviewing the possible implications of changes that have occurred in the structure of DBS's holdings for the third portion.

B. An existing annual bonus plan is in place for the CEO of DBS for 2010, based on the rate of achievement of certain goals defined in the plan and a retention plan that entitles the CEO to a bonus dependent on his performance at DBS during the period stipulated therein. In 2010, the CEO of DBS also received a payment under an amendment to his employment agreement. An annual bonus plan also exists for other officers. It is based on attaining annual targets, and the issue of bonuses is subject to approval by the DBS Board of Directors. Furthermore, annual bonuses are granted to other managers and employees at the discretion of DBS.

5.12.5 Benefits and the nature of employment agreements

DBS employees are employed under personal employment agreements, on the basis of a monthly salary or an hourly wage, with some of the employees also entitled to performance-based compensation. The employment agreements are generally for an undefined period, and each party may terminate the agreement by prior notice in accordance with the agreement or the law.

In January 2010 the New General Federation of Laborers (Histadrut) began preliminary organization of DBS employees. The Histadrut has set up two action committees and claimed it represents over one third of the technicians who are DBS employees, and that it is entitled to conduct collective negotiations with DBS on their behalf. DBS rejected this claim. Since April 2010, DBS has not been contacted at all by the Histadrut.

DBS employs people at the Telephone Service Call Center, in Engineering and Information Systems on the weekly day of rest and on days of rest prescribed by the State, and it has an appropriate permit for such employment.

5.13 Suppliers

For a description of the engagement with Spacecom, which has the exclusive rights and is the exclusive provider of space segments used by DBS, and upon which DBS is highly materially dependent, see Sections 5.8 and 5.18.1.

For a description of the engagement with ADB and Eurocom Digital Broadcast for the purchase of decoders, see Section 5.9.2.

For a description of the engagement with NDS, upon which DBS is dependent with respect to the supply of broadcasting and encryption operating services, see Section 5.9.4.

With respect to dependence on the purchase of the broadcasting rights of local sports channels from these two content providers, see Section 5.11.4.

5.14 Working Capital

5.14.1 Customer and supplier credit

DBS collects subscriber fees from its customers at the beginning of each calendar month for the previous calendar month.

The following is information regarding supplier and customer credit in 2010:

	Average credit in NIS millions	Average credit days
Customers[73]	169	39
Short-term suppliers	356	111
Long-term suppliers	54	*

(*) See Section 5.18.6 for information about the payment agreement with the Company and Bezeq International.

[73] Less doubtful debts.

5.14.2 Working capital deficit

At December 31, 2010, DBS's working capital deficit amounted to approximately NIS 621,491,000.

5.15 Financing

5.15.1 Average interest rate on loans

	Source of financing	Amount at December 31, 2010 (NIS millions)	Currency or linkage	Average interest rate in 2010	Effective interest rate in 2010
Short-term loans	Banks	86	CPI-linked NIS	4.73%	4.83%
Long-term loans	Banks (1)	521	CPI-linked NIS	5.6%	5.64%
	Non-bank (2)	1,087	CPI-linked NIS	8.17%	8.37%
	Shareholder loans(3)	2,300	CPI-linked NIS	6.32%	6.42%

(1) Through December 31, 2010, the long-term bank loans bore 5.6% annual fixed interest. As of December 31, 2010, some of these loans began bearing fixed interest at an average rate of 6.63%, and others variable interest at an average rate of prime plus 1.8%.

(2) The non-bank credit, which is valid as of December 31, 2010, comprises debentures (see Section 5.15.5). In 2010, the loans DBS took from institutional bodies in 2005 were repaid (see Section 5.18.5).

(3) Loans extended to DBS by its shareholders are linked to the CPI and are divided into three types: A. Non-interest bearing loans; B. Loans bearing annual interest of 5.5%; C. Loans bearing annual interest of 11%. See also Section 5.18.4 below and Note 16 to DBS's 2010 financial statements..

5.15.2 Credit restrictions applicable to the company

DBS received bank credit under a financing agreement between DBS and a consortium of banks that provided DBS with long- and short-term banking finance (**"the Financing Agreement"** and the **"the Banks"**, respectively). In 2010, another bank joined the consortium of banks. The bank credit is made up of short-term credit extended to DBS under a credit facility which expires, under an amendment to the agreement in 2010, at the end of 2015, and long-term credit repaid in accordance with a payment schedule that ends at the end of 2015.

In March 2010, pursuant to the additional bank's entry into the consortium of banks, the joining bank provided DBS with its relative share in the current DBS credit facilities, and thus extended DBS long-term credit of NIS 255 million, most of which was used to join it (according to its relative share) with the DBS long-term credit facilities, with repayment and early repayment of DBS debts to the current banks, and its balance of NIS 46 million, was earmarked for DBS current needs. In the agreement for the entry of the additional bank, the financial covenants with which DBS must comply were amended.

At the date of this report, following an additional amendment to the Financing Agreement of November 2010, DBS must comply with the debt coverage ratio (based on the ratio between DBS's cash balance and cash flows over the past 12 months and the principal and interest payments over the coming 12 months), and the maximum and minimum supplier credit covenant (after the amendment of the covenants in November 2010). The compliance of DBS with these covenants is measured quarterly, and failure to comply with these covenants, subject to extensions stipulated in the Financing Agreement, grants banks the right to demand early repayment of the loans. As part of said amendment, the Financing Agreement further stipulated a mechanism according to which if the Company's debentures (Series B) are downgraded below ilBBB (or its equivalent, whichever is lower), the annual interest paid to the banks will increase by 0.25% in respect of each notch on the rating scale, as long as the downgrade is in effect.

At December 31, 2010, DBS was in compliance with the financial covenants under the Financing Agreement. On June 30, 2010 and September 30, 2010, DBS was in compliance with the covenants after dispensations it had received from the banks regarding the target of one of the covenants for those dates, which was required given the material provisions DBS set aside, as aforementioned in Section 5.11.1.

In addition to the financial covenants set out above, under the Financing Agreement additional restrictions stipulated therein apply to DBS. These include: restrictions on its compliance with the business plan, updating of the plan and engaging in operations that are not an integral part of its current operations; restrictions on the assumption of third-party liabilities, including the receipt and extension of credit; restrictions on the distribution of profits and payment of management fees or similar payments to shareholders; restrictions on the creation of pledges and sale of certain assets without consent from the Banks; restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures); restrictions on the shareholder loans given to DBS, including their inferiority to the bank credit (and to debentures issued to the public, if any), and restrictions on the repayment thereof prior to repayment of bank credit in full, except in respect of shareholder loans given to DBS after April 1, 2004, which DBS may repay on account thereof prior to full repayment of the bank credit, under the conditions set out in the Financing Agreement; Restrictions on the allotment of shares or other DBS securities without the consent of the Banks, except for the allotment of securities to DBS shareholders which was permitted under the conditions set out in the Financing Agreement.

DBS is bound to make mandatory repayment of sums that it receives in respect of the issue of shares or debentures to the public, sale or transfer of property and certain cash flow surpluses of DBS, on the conditions and at the rates set out in the Financing Agreement. DBS may, voluntarily, effect early repayment sums received in respect of issue of shares or debentures to the public, which may remain after the aforesaid mandatory repayment, on such conditions and at such rates as are set out in the Financing Agreement, with the agreement defining the rate of receipts from the issue of DBS debentures (Series A) in the event the series is expanded, if such occurs, to be used to repay the bank credit. DBS is entitled to repay, voluntarily, through early repayment, amounts to be received with respect to the public issue of shares or debentures, to remain after the performance of said mandatory repayment, under the conditions at the percentages stipulated in the Financing Agreement.

The Financing Agreement officially defines events that constitute breach and entitle the banks, under the conditions stipulated in the Financing Agreement, to call in the bank credit for immediate repayment, including various breaches of the Financing Agreement, liquidation and receivership proceedings against DBS, cancellation or suspension or the broadcasting license, unauthorized changes in ownership of the means of control in DBS, violations of the undertakings of the shareholders to the banks and breach of material agreements defined in the Financing Agreement.

With respect to restrictions on taking additional credit by virtue of the DBS debentures, see Section 5.15.5.

5.15.3 DBS has created a floating charge in favor of the Banks, and has created fixed charges in favor of the Banks over its rights under material agreements to which it is party, over its unissued registered capital, its goodwill, certain intellectual property rights, and over the insurance rights to which it is entitled under the insurance policies issued to it (the charge does not apply to DBS's rights under its broadcasting license). These charges were taken at equal rank, pari-passu, with similar charges created by DBS in favor of its debenture holders (see Section 5.15.5). In 2010, the additional bank joined this series of charges.

5.15.4 Eurocom DBS, the largest shareholder in DBS,[74] placed a charge on DBS securities it held and the rights to repayment of the shareholder loan it extended to DBS in favor of the Banks, to secure the amounts the Banks provided and will provide to DBS. DBS shareholders have confirmed to the Banks that until full repayment of the bank credit, the shareholder loans will be subordinate to the bank credit, there will be no disposition thereof

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[74] For details on the trust of Eurocom DBS shares, the terms of the merger stipulated by the Anti-Trust Commissioner, see Section 1.2.1 above.

and that they will not demand their repayment on any collateral for their security. On November 23, 2000 the Company gave a guarantee of DBS's debts to the Banks, provided that the amount which the Banks receive in repayment by the Company in respect of its guarantee does not exceed the value of its shares in DBS on the date on which the Banks realize the shares which the other shareholders pledged in their favor. The Company also undertook that in the event a negative pledge the Company gave in favor of its creditors is released (see Note 14 to the 2010 Financials), the Company would charge its shares in DBS, a first ranking charge in favor of the banks. Furthermore, the Company warranted to also put its shares up for sale in the event the Banks sell the charged shares. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders, the Company would waive repayment of the shareholder loans it granted to DBS. The Company also consented that its guarantee would also apply, mutatis mutandis, to the options to be allotted to it by DBS and to the right to receive them. Eurocom DBS and the Company undertook to the Banks inter alia not to oppose the sale or other realization of their shares in DBS, which had been pledged (by Eurocom or DBS) or in respect of which a guarantee had been given (by the Company), such that the Banks could make the sale in the form of a friendly liquidation.

5.15.5 Issuance of debentures

A. In July 2007, DBS raised approximately NIS 620 million as part of a private issuance to institutional investors of registered debentures (Series A) which were listed on TACT Institutional at TASE (**"the Debentures (Series A)"**), in accordance with a deed of trust between DBS and Hermetic Trust (1975) Ltd. (**"Trustee A"** and **"Deed of Trust A"**, respectively).

The Debentures (Series A) are to be repaid in eight annual (unequal) principal payments, in July 2010-2017,[75] which at the date of this report bear annual linked interest at a rate of 8.4% per annum paid in semi-annual installments (principal and interest). The terms of the Debentures (Series A) include mechanisms to reduce the interest rate if the debentures are registered for trade on the stock market (to annual rate of 7.4%), and a mechanism for an interest supplement in the event that DBS pays an interest supplement in respect of the bank credit due to failure to comply with the financial covenants stipulated in the Financing Agreement and the Debentures (Series A) are not registered for trade at that time.

In Deed of Trust A, a restriction was stipulated that is dependent on the EBITDA of DBS, relating to DBS's right to register a first-ranking charge in favor of the holders of additional securities, and/or allow them to participate in charges in favor of the Trustee, without requiring the Trustee's consent.

Deed of Trust A sets out various agreed events (such as insolvency, breach, realization of charges on the main DBS assets, etc.), the occurrence of which, after a warning period stipulated in the deed, entitles the Debentures to be called in for immediate redemption subject to the provisions of the Deed of Trust. Immediate redemption can also be demanded in the event of realization of the Banks' collateral (as defined in subsection C) or the calling in of another series of Debentures issued by DBS for immediate redemption, or if the balance to clear exceeds the amount stipulated in the deed.

For the rating of the Debentures (Series A), DBS undertook to S&P Maalot (and solely to it) that it would not perform a redemption at the expense of the shareholders loans until end of the lives of the Debentures (Series A).

B. In November 2010, DBS raised the sum of approximately NIS 450 million as part of a private issue to institutional investors of registered debentures (Series B) which were listed on TACT Institutional at TASE (the **"Debentures (Series B)"**), in accordance with a deed of trust between DBS and Hermetic Trust (1975) Ltd. (**"Deed of Trust B"** and **"Trustee B"**, respectively).

[75] In each of the years 2010-2013 the principal payments will be 8% of the par value of the Debentures, and in each following year, the principal payments will be at a rate of 17% of the par value of the Debentures.

The Debentures (Series B) are to be redeemed in eight (unequal) annual principal payments, in November 2013-2019[76], which bear annual CPI-linked interest at a rate of 5.85% per annum paid in semi-annual installments (principal and interest). The terms of the Debentures (Series B) included a mechanism for a 0.5% reduction in the annual interest rate should the debentures be listed for trade on the stock exchange and in the event the Company provides a guarantee for the holders of the debentures (Series B), and mechanisms for a 0.5% supplement the annual interest paid if the Company's debentures are downgraded to ilBBB or its equivalent, and a supplement of 0.25% to the annual interest in respect of each notch on the rating scale, as long as the downgrade is in effect Should the Company provide a guarantee in favor of the holders of Debentures (Series B), the interest supplements, if any, in respect of the downgrading rating, will be cancelled.

In Deed of Trust B a restriction was stipulated with respect to the right of DBS to record first-ranking charges to the holders of additional securities that may be issued by DBS (either through expansion of the series or in the event of the issue of another series or additional securities) and/or allow them to participate in charges in favor of the Trustee, without requiring the Trustee’s consent, which is dependent on the ration between the DBS's total secured debt and its EBITDA in the 12 months prior to said date and the rating of the debentures (Series B0 not being downgraded at that time (to the extent their rating does not exceed the initial rating - see subsection F below).

Additionally, Deed of Trust B sets out various agreed events (subject to the extensions), which if they occur, entitle the Debentures to be called in for immediate redemption subject to the provisions of the Deed of Trust. These events include the events included in this regard in Deed of Trust A, with certain changes, and additional events, including failure to submit financial statements to the trustee on the dates stipulated in the deed, decrease in the Company's rate of holding in DBS to below the minimum rate stipulate in the deed (as long as DBS is a private company), merger with another corporation (except with a company or corporation it controls) or sale of its main assets under the terms stipulated in the deed, cancellation of the broadcasting license or termination of activity in the field of communications, and non-compliance with the financial covenant stipulated in the deed based on the ratio between DBS's secured debts and its EBITDA (as they are defined in Deed of Trust B and subject to the term of amendment stipulated in the deed).

Deed of Trust B includes a restriction on the right of DBS to pay dividends and repayment on account of the shareholders loans in its compliance with the financial covenant based on the ratio between the total secured debt and its EBITDA (as they are defined in Deed of Trust B, and subject to the amendment periods stipulated in the deed), and with respect to the repayment of shareholder loans, there is an additional restriction according to which the amount of repayment shall not exceed the net accumulated profit of DBS from the beginning of 2011 forward, less financing expenses of DBS in respect of shareholder loans and less repayments or distributions made.

DBS is looking into the possibility of expanding the debenture series (Series B), by the issue of additional debentures for NIS 120 million, according to orders it received from institutional bodies and this subject to the approval of the banks and approval of the rating company that the rating will not be downgraded as a result. 50% of the consideration from the issue is designated for early repayment of part of the loan-term credit DBS was extended by the banks. At the date of this report, orders have been received from institutional bodies, as aforementioned, although the expansion of the series has not yet been approved and the approvals for such have also net yet been received.

C. The Debentures (Series A) and Debentures (Series B) are each secured by a first ranking floating charge, unlimited in amount, on all of DBS's assets (aside from exceptions attributable to the provisions of the Communications Law) placed by DBS in favor of the trustee of the relevant series, including a covenant that restricts the creation of additional charges (aside from exceptions stipulated in the deed of trust), and in a first ranking fixed charge, unlimited in amount, in favor of any such trustee, on

[76] In each of the years 2013-2017, the principal payments will be 14% of the par value of the Debentures, and in each following year, the principal payments will be at a rate of 15% of the par value of the Debentures.

the rights and assets of DBS that were charged by it in favor of the banks (aside from exceptions attributable to the provisions of the Communications Law) (**"Trustee Collaterals"**). The Trustee Collaterals, as aforementioned) are first ranking and equal (pari passu) to the floating charges and the fixed charge placed by DBS in favor of the banks to secure the bank credit ("Bank Collaterals") and between the series of debentures themselves. The creation of additional charges by DBS in favor of the banks is subject to the approval of the trustee, unless said charges are also registered in favor of the trustee. In any event of realization of the Trustee Collaterals and/or Bank Collaterals and/or sale of the assets subject of these collaterals, including by the holders of other securities who will receive a charge on said assets, the receipts of such exercise will be divided pro rate between the trustee, banks and the holders of both debenture series, with each charge holder receiving its relative share of the receipts equal to the relative share of the debt to it (as defined in the deed of trust) divided by the total secured debt in said assets.

D. According to the provisions of Deed of Trust B, in the event Trustee B is given a guarantee by the Company for the liabilities of DBS to the debenture holders (Series B), and the rating of the Company does not fall below -ilAA or the corresponding rating with a different rating company (the higher of the two), then as of said date and as long as the Company's rating did not fall below the aforementioned rating, the collaterals DBS created in favor of Trustee B will be cancelled, the restriction on expansion of the series and the issue of additional securities secured by said collaterals, the restriction regarding the repayment of the shareholder loans and payment of dividends will be cancelled and the number of causes for immediate redemption available to Trustee B under Deed of Trust B will be cancelled (in addition to the drop in the annual interest rate as aforementioned).

E. For additional information regarding the Debentures (Series A) and Debentures (Series B), see Note 14 to the DBS 2010 Financials.

F. Changes in the rating of the Company and rating of the debentures by S&P Maalot in the reporting period

	Debentures (Series A) and Company rating	Debentures (Series B)
5.7.07	-ilBBB - rating on date of the issue	
13.4.10	Rating upgraded to ilBBB	
6.7.10	Rating upgraded to +ilBBB	
13.10.10	Placed on credit watch with positive implications	
31.10.10	Upgraded to -ilA, among other reasons in view of the expected improvement in DBS' liquidity in the short term following the issue of Debentures (Series B) and in view of the amendment to the Financing Agreement that included a list of the financial covenants with which DBS must comply.	-ilA - rating on date of the issue
1.3.11		Rating of ilA- for additional debentures of up to NIS 120 million par value, to be issued in a series expansion.

5.15.6 The corporation's credit facility (in NIS thousands)

Credit facility	Use at December 31, 2010	Use at February 27, 2011
114,060	88,467	64,184

For information, see Note 28 to the DBS's 2010 financial statements.

5.15.7 Estimate regarding the need to raise sources of financing in 2011

According to the payment schedule of the Financing Agreement and DBS's debentures, in 2011 DBS is expected to repay NIS 217.5 million on account of principal and interest of its loans (regarding the possibility of additional repayment of bank credit through some of the consideration from expansion of the Debenture Series (Series B), if performed, see Section 5.15.5.B).

DBS management estimates the sources of financing available to it will be sufficient for its operations in the coming year, and this according to the cash flow forecast that was approved by the DBS Board of Directors. Should additional sources be necessary for operations in the coming year, DBS will adjust its activity such that it will not require additional sources beyond those available to it.

In recent years DBS needed to raise external financing sources, *inter alia*, to increase its investments. As at the date of this report, a significant increase of DBS's investments would require expansion of the sources of financing available to it (for restrictions regarding additional credit, see Sections 5.15.2 and 5.15.5).

5.16 Taxation

For information regarding DBS taxation, including proceedings regarding an assessment in respect of input tax issued to DBS and proceedings that ended in the year of the report regarding the transaction assessment issued to DBS, see Note 27 to DBS's 2010 financial statements..

5.17 Restrictions on and supervision of the company

5.17.1 <u>General</u>

DBS’s operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The above legislation, secondary legislation, resolutions of the Council and administrative directives have a material impact on DBS and its operations. Likewise, legislation and secondary legislation in the fields of communications and consumer protection have a material impact on DBS.

Restrictions are applicable to DBS under the Communications Law and the regulations promulgated thereunder.

Pursuant to the Communications Rules (Broadcasting Licensee) 1987 (the “Communications Rules”), various obligations and restrictions apply to DBS, including those relating to broadcasting content and the total and manner of investment in local productions.

Additionally, DBS's operations are subject to the provisions of its licenses, and particularly the broadcasting license[77].

5.17.2 <u>Eligibility requirements for licensee for satellite broadcasts, restrictions on cross-ownership</u>

The regulations of the satellite broadcasting license place various restrictions on a licensee, including eligibility requirements for a licensee for satellite requirements that relate to the holdings of the owner of the broadcasting license and the interested parties, directly and indirectly, in the licensees under the Law of the Second Authority and the owners of daily newspapers. In 2008, the Ministry of Communications informed DBS of what it claimed to be a violation of the eligibility restriction stipulated in the Satellite Broadcasting Regulations, in view of the holdings of Bank Leumi Ltd. both in DBS (under a charge in its favor on shares of its issued capital) and Keshet Broadcasting Ltd. In April 2010, a subsidiary of Bank Leumi informed DBS that it had complete a transaction for the sale of all its holdings in Keshet Broadcasting Ltd. and, thus, to the best of DBS's understanding, the issue has been resolved.

5.17.3 <u>Royalties</u>

Under the Royalties Regulations (Satellite Broadcasts), DBS must pay royalties on its revenues from provision of broadcasting services. For information regarding the percentage of royalties and in the increase in the percentage of royalties in 2011 and 2012,

[77] The full version of the broadcasting license is available of the Ministry of Communications website: www.moc.gov.il.

see Section 1.7.3.C. In respect of 2009, DBS paid approximately NIS 13.5 million in royalties (the percentage of royalties that year was 1.5% of the relevant revenues). In respect of 2010, DBS paid a total of NIS 9.6 million in royalties (the rate of the royalties this year was 1% of the relevant revenues).

5.17.4 Tariff regulation

The broadcasting license stipulates provisions regarding the types of payments the broadcasting licensee may collect from its subscribers. DBS is obligated to inform the Chairman of the Council of any change in the price list approved by the Council immediately upon its publication, and the Chairman is entitled in certain cases to prohibit the change in the price list. The Chairman of the Council is further entitled to intervene in special offers or discounts offered by DBS, if he finds that they mislead the public or discriminate between subscribers.

Under Section 6(49) of the Communications Law, the license may stipulate maximum prices that can be charged to subscribers. At the date of this report, no such prices had been set.

5.17.5 Requirement to invest in local productions

In accordance with the requirements of the broadcasting license and the decisions of the Council, for each of the years 2010 and 2011 DBS must invest in local productions an amount which shall not be less than 8% of its revenues from subscription charges. Despite the fact that DBS's total investment in local productions in 2008 exceeded 8% of its revenues, the Council informed DBS in October 2009, among other things, that DBS had not complied with its obligation to invest in local production on the channels owned by external producers in 2008 and that DBS had not complete the shortfall in this category in 2007. The Council further stated that DBS failed to live up to its obligation to invest in television movies, cinema, complex drama and mini dramas in 2008 and did not complete the shortfall from the past in this category. The Council gave notice that DBS was to complete these shortfalls from 2008 as well as the shortfalls from previous years in said categories in 2010 and 2011. DBS disputes some of the determinations of the Council, and it has contacted the Council in an attempt to change its decision.

At the date of this report, an inquiry is being conducted by the Council and DBS regarding the Council's allegations of purported violations of the requirement to invest in 2009 in several categories.

5.17.6 Requirement to transmit channels

In accordance with the requirements under the law and license, DBS is required to allow the producers of channels set out in the law to use its infrastructures to transmit broadcasts to its subscribers, and this in exchange for payment ("Transmission Fee") to be determined in the agreement, and lacking agreement - in exchange for a payment to be determined by the Minister, after consulting with the Council.

In March 2009 the Ministry of Communications announced a hearing on the amount of the transmission fee, noting that the results would serve as the foundation for the decision on the dispute between DBS and the dedicated channels (lacking an agreement between them), and the amount of the payment to be determined in the hearing will apply from 2007 through the end of 2013. The parties will be able to use the calculation method to calculate the amount of the payment through 2006. The Ministry of Communications noted that its economic opinion, which it attached to the hearing, could serve as the basis for settlement of other disputes that may arise between DBS and other independent channel producers. In November 2010, as part of the hearing, DBS received the economic opinion of the Economic Department at the Ministry of Communications. According to the opinion, the annual usage fees would amount to NIS 2 million for an independent channel producer that is not financed by subscription fees. At the date of this report, the decision of the Minister in this regard has not yet been received.

In accordance with an amendment to the Communications Law in July 2010, the dedicated channels are exempt from payment of transmission fees to HOT and DBS. In September 2010, DBS filed a claim with the High Court of Justice against the validity and applicability of this amendment. For details on the claim, see Section 5.19.

5.17.7 Content of the broadcasts and obligations with respect to subscription

The broadcasting license sets out a number of provisions that relate to the content of DBS's broadcasts, including the Council's approval of the channels broadcasted by DBS and approval of the electronic program guide (EPG) which is part of DBS's digital service to its subscribers. The Communications Law prohibits the broadcast of advertisements, subject to several exceptions (this prohibition also applies to HOT).

Additionally the broadcasting license includes conditions regarding the terms of the services to subscribers and prohibition of discrimination between subscribers as well as an obligation to have the Council and the Standard Contracts Tribunal approve the subscriber agreement.

5.17.8 Restrictions on term of commitment

As of December 2010, subscribers can no longer be signed up for special offers that include a term of commitment by the subscriber to use the services for more than 18 months (this restriction does not apply to subscribers that signed up for special offers up to December 2010). It was also prohibited to offer subscribers various terms of commitment for different service components. In accordance with the decision of the Council, as of January 2011, DBS is entitled to collect the cost of the benefit from subscribers who signed up for a special offer that includes a term of commitment and ask to be disconnected from its broadcasts prior to the end of the term of commitment. This is equal to the lower of the following two amounts: Return of the cost of the benefit stipulated in the special offer or the balance of the payments the subscriber would have had to pay had the subscriber remained connected to DBS's services through the end of the term of commitment.

With respect to the memorandum on the amendment to the Communications law regarding restrictions on the exit fee the licensee may collect from its subscribers, see Section 1.7.3.D.

5.17.9 Ownership of broadcast channels

According to the communications rules, DBS, including its associated entities which are defined in the communications rules, may own up to 30% of the local channels broadcast by DBS. (This is in contrast to the 20% applicable to HOT.) Under the Communications Law, DBS is also restricted on the broadcast of news broadcasts.

5.17.10 General provisions regarding the broadcasting license

The Minister and the Council have parallel authority to amend the broadcasting license. The Minister was authorized to cancel or postpone the broadcasting license for causes set out in the Communications Law and the broadcasting license. The Communications Law and broadcasting license stipulate restrictions on the transfer, attachment and encumbrance of the broadcasting license and any of the assets of the broadcasting license. The broadcasting license requires receipt of the approval of the Minister for specific changes in the holding of the means of control in DBS and imposes a reporting requirement regarding the holders of the means of control; hurting competition in terms of provision of broadcasts and services is prohibited, including terminal equipment and other telecommunications services unless approved in advance and in writing by the Council; the obligation to file reports to the Ministry of Communications was defined as well as conditions regarding the regulation of the activity of the licenses; an obligation was stipulated to provide bank guarantees of NIS 30 million (principal) to the Ministry of Communications to guarantee DBS's undertakings under the license (in order to issue these guarantees, DBS shareholders provided securities to the issuing banks).

With respect to the restrictions stipulated regarding DBS as part of acquisition of control of the Company by B Communications, see Section 1.3.1.A.

5.17.11 Consumer Protection Law

Under the Consumer Protection Law, there is an obligation to provide notice of the end of a term of a transaction and to receive the approval of the customer to extend the engagement beyond the specified term of the transaction.

5.17.12 Wiring in subscribers' homes

When a subscriber switches from HOT to DBS and vice versa, in accordance with the administrative directives issued by the Ministry of Communications, which regulate how the subscriber is transferred and the use of the infrastructures in the subscriber's home, and determines the obligation to pay a monthly usage fee in respect of the infrastructure (wiring) that is owned by the other multi-channel television provider. In some subscriber homes, DBS is dependent on the use of the internal wiring that belongs to HOT and the use of which is done under the administrative directive. In the past, disputes arose between DBS and HOT regarding implementation of the administrative directives. In July 2010, an agreement was signed between DBS and HOT, under which DBS paid HOT an agreed amount to clear its demands with respect to the use of infrastructure in subscriber homes through the end of 2010, and it was determined that as of 2011, there would no longer be a requirement of either of the parties to pay the other party in respect of the use of the wiring in accordance with that set out in the agreement. In September 2010, DBS and HOT contacted the Ministry of Communications with a request to amend the administrative directives, to cancel the obligation to provide prior notice of the connection to the other licensee prior to performance of the actual connection in the event a subscriber switches between licensees, such that the licensee to which the subscriber connects will submit the notice of disconnection from the subscriber to the licensee from it was disconnected only after performance of the connection to the other licensee. The Ministry of Communications has not yet issued a decision on this matter.

5.18 Substantial agreements

Following is a brief description of the main points of the agreements likely to be considered as material agreements not in the ordinary course of DBS's business, which have been signed and/or are valid in the period of the Periodic Report:

5.18.1 Space segment lease agreements

DBS and Spacecom Communications Ltd. (**"Spacecom"**), a company jointly controlled by Eurocom DBS, the largest shareholder in DBS, have an array of agreements under which DBS uses the space segments via Amos 2 and Amos 3 satellites (**"Space Agreement"**).

In the past the Space Agreement applied to use of the space segments via Amos 1, the use of which ended in 2008 (the holder of the rights to this satellite, Israel Aircraft Industries Ltd., was also a party to the engagement. In May 2010, DBS completed repayment of its debt to Israel Aircraft Industries Ltd. in respect of the use of Amos 1 satellite).

Pursuant to the Space Agreement, the term of use of the space segments on satellites AMOS 2 and AMOS 3 is through April 2016 or until the end of life of AMOS 2, the earlier of the two. The consideration for use of the space segments consists of annual usage fees to be paid in monthly installments, the amount of which depends on the total number of segments supplied by Amos 2 and Amos 3 to DBS, its shareholders and entities affiliated with DBS and/or with its shareholders, as defined in the Space Agreement.

Under the Space Agreement, if the supplied capacity becomes unusable, Spacecom shall make every effort to provide alternative capacity, and if Spacecom is not able to do so, it will work to provide such through a satellite belonging to another operator. Should the cost of the alternative capacity exceed that set out in the agreement, Spacecom will participate in half of this cost alone, provided that it does not exceed USD 50,000 per segment annually. Should work be required to adapt the ground infrastructure in subscriber homes, Spacecom will bear the costs that apply to DBS, up to USD 2,500,000, with DBS bearing the remaining costs.

DBS was also granted the right of first refusal for additional space segments on AMOS 2 under the terms specified in the agreement.

Pursuant to the Space Agreement, DBS must use 13 space segments, and while DBS may temporarily stop using a single segment, each party is entitled to bring about its renewed use (once a year). A mechanism was set up for partial backup on Amos 3 in the event of non-availability of space segments on Amos 2. Additionally, Spacecom undertook to make every reasonable effort to back up on Amos 2 in the event of non-availability of both space segments used by DBS on Amos 3, at the date of this report.

At the date of this report, DBS is using ten space segments on Amos 2 and two space segments on Amos 3 (in view of its right to terminate the lease of the 13th segment, as aforementioned). The lease fees in 2010 amounted to approximately NIS 87 million.

DBS is materially dependent on Spacecom, as the exclusive holder of the rights and the sole provider of space segments used by DBS, which is also responsible for operation of the space segments. With respect to exposure to risks in the event Amos 2 or Amos experience operations failure, see Section 5.22.2E.

5.18.2 Financing agreement with the Banks

For a summary of the main points of the agreement, see Section 5.15 and Note 5 to DBS's 2010 financial statements.

5.18.3 Deeds of trust regarding Debentures (Series A) and Debentures (Series B)

For a summary of the main points regarding the deeds of trust, see Section 5.15.5.

5.18.4 Agreements with DBS shareholders[78]

A. The founders agreement dated December 4, 1998, between the shareholders of DBS, which regulates the establishment and management of DBS as well as the relationships between the shareholders.

B. An agreement dated December 30, 1998 between DBS's shareholders and DBS regulates, inter alia, the establishment and authorities of an executive committee.

C. An agreement dated November 2001 between DBS's shareholders and DBS, changed the dilution formula set forth in the founders agreement and stipulated that the holdings of DBS's shareholders would be adjusted to the pro rata share of their investments in DBS, such that for the purpose of dilution, the investments (made by way of shareholders' loans) would bear, as of the date fixed in the agreement, CPI linkage differentials and an annual cumulative linked interest rate of 5.5% from the date of the establishment of DBS.

D. An agreement dated December 30, 2002 as amended on August 6, 2003, between DBS shareholders and DBS, prioritizes shareholders' loans granted subsequent to July 10, 2002 over earlier loans. The agreement also stipulated that these loans would bear CPI linkage differentials and an annual accrued linked interest rate of 5.5%, while loans granted after April 27, 2003 would bear CPI linkage differentials and an annual accrued linked interest rate of 11%. Furthermore, the agreement stipulated a mechanism for the allotment of shares or option warrants to shareholders who would invest in DBS, such that their holdings in DBS would be adjusted to their adjusted investments in it. The agreement also stipulated the information rights for the shareholders who are parties thereto.

5.18.5 Agreements with institutional bodies

Through November 2010, DBS was engaged through agreements from 2005, loans were provided to DBS by a number of institutional bodies, in the total sum (principal) of NIS 100 million, linked to the CPI and bearing interest at an annual rate of 11%, the date of repayment of which is December 31, 2013. As collateral for these loans, the Company undertook to repay amounts on account of the loans, the amount of which would be determined by the fixed formula in the agreements. These loans were repaid through early repayment in November 2010.

5.18.6 Agreement with the Company and with Bezeq International

In May 2010, DBS and the Company put together an arrangement regarding the amount of DBS's debt to the Company in respect of various communications services at July 31, 2009, in view of the dispute that arose between the parties. In October 2010, the agreement to defer part of the payments under said arrangement was approved as well as

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78 These agreements were also signed by additional shareholders, whose holding in DBS were sold to Eurocom DBS and, therefore, at the date of this report, the parties to these agreements are Eurocom DBS and the Company.

deferral of payments DBS owed to the Company under a previous agreement between it and the Company for the rescheduling of DBS's debt in respect of the purchase of Internet infrastructure in the amount of NIS 45.5 million. The rescheduling agreement can be cancelled with advance notice, under the terms stipulated therein. Additionally, in October 2010 a similar rescheduling agreement with Bezeq International Ltd. was approved regarding a debt of NIS 8 million. The arrangements were approved as a transaction in which the controlling shareholder of the Company had a personal interest. For more details, see the supplemental report to the transaction report and the notice to convene an extraordinary meeting dated April 14, 2010, as well as a transaction report and notice to convene an extraordinary meeting dated September 6, 2010 (regarding engagements A and B in said report), brought by way of reference.

5.19 Cooperation Agreements

In January 2011, DBS and the Company signed agreements pursuant to which DBS will market the Company's telephony and Internet infrastructure services, including as part of a joint basket of services, and the Company will market DBS's television services, including as part of the joint basket of services. The Company's entry into the agreements was approved as a transaction in which the controlling shareholder has a personal interest (for additional information see the transaction report and the notice to convene an extraordinary meeting dated September 6, 2010, regarding engagement (in the aforementioned report). At the date of this report, the parties have yet to operate pursuant to these agreements.

5.20 Legal Proceedings

Following a revision of the materiality threshold of the Group as of October 1, 2010, this annual report will include comments and/or revisions regarding the legal proceedings that account for 5% or more of the net profit from the ongoing activity of the Group (approximately NIS 130 million or higher[79]) according to the Company's most recent annual financial statements (consolidated) and the legal proceedings in which the amount claimed was not specified in the statement of claim, unless relating to a claim which would not seem to reach the aforementioned quantitative threshold (and all unless additional aspects and/or implications for the proceeding exist beyond its financial total)[80].

5.20.1 <u>Pending legal proceedings</u>

A. In July 2006, DBS filed a monetary claim of NIS 31.5 million with the Tel Aviv District Court against Pace Micro Technology plc ("Pace") n respect of payment of its direct expenses for the repair of a model of defective set-top boxes which was manufactured and supplied by the defendant pursuant to a framework agreement from August 1999 between DBS, the defendant and Eurocom Digital Communications, where in the agreement it undertook to provide repair services for the set-top boxes. On July 15, 2007, a statement of defense was filed by the defendant and in conjunction therewith it filed a statement of counterclaim against DBS and against Eurocom, jointly and severally, in the amount of NIS 42.6 million. The defendant argues in its statement of defense and counterclaim that the liability for the failures of the set-top boxes should not be imposed on it, but on DBS and/or Eurocom, and it argues that this is, *inter alia*, because the set-top boxes were not designed appropriately by the counter defendants, were not properly tested by the counter defendants, and because at least some of the decoders were not properly installed in subscriber homes by DBS or by its contractors. In the counterclaim, various damage related to the repair of the set-top boxes, related expenses and loss of profit are alleged.

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79 To examine whether the amounts of the claims meet said threshold, the amounts were linked to the CPI. The amounts noted in this section are the original amounts, without linkage differentials. With respect to said threshold, should there be similar proceedings against several companies in the Group, the amount of the claim may be examined cumulatively in respect of all the proceedings together.

80 Therefore, this report does not include updates regarding proceedings described in the Company's reports in 2010 and which do not reach said materiality threshold, as follows: A claim from July 2010 that was described in the Company's financial statements for the second quarter of 2010, and a petition with the HCJ in respect of the transmission fees of the dedicated channels that was described in the financial statements for the third quarter of 2010.

The parties reached agreement in principle on a settlement and withdrawal of the claim filed by DBS against Pace and the counter-claim filed by Pace against DBS and against Eurocom Digital Communications. In the settlement, all these legal proceedings will end without any of the parties admitting the allegations of the other parties, DBS will purchase converters from Pace (for a total of USD 4.158 million) and Pace will supply DBS with an additional quantity of converters free of charge (the total value o0f which, under the terms of the converter purchase transaction, is approximately USD 1.8 million). The settlement agreement has not yet been signed.

B. In 2007 an application for certification of a class action against DBS was filed in the Tel Aviv District Court for reception disturbances in DBS's broadcasts and problems in the functioning of DBS's service system during the reception disturbances in September 2007. The applicant argues that in September 2007, daily malfunctions and long interruptions in television broadcasts were caused to DBS's subscribers which took the form, inter alia, of severe disturbances of picture and sound, and DBS's service center was not operational and it was impossible to receive service or assistance from it

The applicants estimated the claim at NIS 121 million.

The summations in the case are to be filed by March 20, 2011. There have recently been discussions between the parties in an effort to examine the possibility of ending the proceeding by settlement.

C. On October 7, 2010, an application for certification of a class action against DBS was filed in the Tel Aviv District Court for NIS 98 million. According to the applicant, DBS did not live up to its obligation to provide the applicant and its customers with a document that outlines their right to cancellation should they make a change and/or addition to the service provided to them under the "ongoing transactions" with it, and according to the applicant the result was that it incurred financial damages of NIS 124, which is the difference between the payment it made in respect of the new converter and the amount it paid for the converter prior to the change over a period of three months, and non-financial damage of NIS 50 in respect of harm to personal autonomy. The applicant estimated that the total number of members of the relevant group is approximately one million subscribers. The final date for filing of DBS's response to the application for certification is February 23, 2010. Similar claims (by plaintiffs represented by the same attorney) were also filed against the Company, Pelephone and Bezeq International - see Sections **Error! Reference source not found.**, **Error! Reference source not found.**N and **Error! Reference source not found.**.

D. On November 1, 2010, an application for certification of a class action against DBS was filed in the Tel Aviv District Court for NIS 258 million (sums in respect of monies unlawfully collected each month from each and every member of the group are expected to be added to this amount). According to the applicant, DBS materially violated the provisions of the Consumer Protection Law regarding a transaction for a defined period of time, and this due to the failure to send a notice to its customers of the end of their term of commitment and collection of improper payments at the end of the term of commitment. The applicant further argues that DBS conditioned the return of the payments unlawfully collected from the customers in the engagement with the Company on another long-term commitment. The applicant argues that as a result she incurred financial damage of NIS 568, which is the full amount she paid as subscriber fee after the end of the term of commitment. In addition, the applicant is suing for NIS 5,000 as exemplary damages and/or damages in respect of non-financial damage incurred by the applicant in respect of the alleged breaches of the provisions of the Consumer Protection Law. The applicant estimates that the relevant group for the application for certification numbers 570,000 customers. The Company must file its response to the application for certification by March 31, 2011.

E. On December 13, 2010, an application for certification of a class action against DBS was filed in the Tel Aviv District Court for NIS 600 million. The applicant alleges that DBS violated its obligation to its customers by omitting broadcasts it is committed to air in the Basic Package, removed channels without approval, did not comply with the obligation to invest in quality genres and violation of obligations regarding the broadcast of commercials, promos and marketing and commercial content. The applicant argues that as a result, he incurred damage estimated at NIS 2,180. This amount comprises NIS 1,680, which is 10% of the total subscription fee the applicant paid in the seven years he was a subscriber of DBS as damages in respect of the damage he incurred due to non-broadcast of the broadcasts the Company is obligated to air, and non-financial damage of NIS 500 in respect of harm to personal autonomy. The applicant defined the group as all of the respondent's subscribers in the seven years prior to the filing of the action. He estimates that the group numbers 800,000 subscribers. The final date for DBS to file its response to the application for certification is March 20, 2011.

F. On December 16, 2010, an application for certification of a class action against DBS was filed in the Tel Aviv District Court for NIS 50 million. The applicant alleges that DBS violated its obligation to its hearing impaired subscribers in that it did not comply with is obligations under the Equal Rights for Persons with Disabilities Law (1998) and under the Television Broadcasting (Subtitles and Sign Language) Law (2005) and violates the directives of the Council in this regard. In accordance with that alleged in the claim, the amount of damages claimed per customer is NIS 10,000. According to the estimate of the plaintiff at least 25,000 of the people suffering from hearing impairment (of the 50,000 he claims are defined as hearing impaired) are DBS customers. DBS has not yet filed its response to the application for certification.

5.20.2 <u>Proceedings that came to a close in 2010</u>

In February 2010, the Tel Aviv District Court dismissed an application for certification of a class action against DBS, The Sports Channel Ltd. (producer of Channel 5, 5+, 5 Live and 5 Gold) and others, regarding 5 Live's broadcasts, in which it was argued that 5 Live's broadcasts involve the transmission of content from 5+ to 5 Live, and this goes against the "fundamental guarantee of DBS which was verified in previous legal proceedings."

5.21 Business objectives and strategy

5.21.1 DBS’s goals are to continue the trend of growth in revenues, by continuing the moderate increase in the number of subscribers, and by continued growth in average revenue per subscriber (ARPU).

5.21.2 To achieve these goals, DBS invests considerable effort in marketing and sales, and in appropriate marketing strategy designed to continue attracting subscribers; retain existing customers and increase revenues from them; continually improve the array of services to subscribers, create differentiation and innovation in its broadcasting content which is to be expanded relative to HOT content, and to increase the amount of content purchased by each subscriber and expand DBS's value-added services. These efforts include DBS's drive to increase the rate of penetration of advanced services, including the PVR and HDPVR decoders and VoD and HD services among its subscribers as well as to also provide its content on additional platforms to increase DBS revenues and enhance subscriber loyalty to DBS's services.

5.21.3 DBS’s goals in respect of increasing the number of subscribers and the ARPU are based on forecasts by DBS's management, on the current trend in the broadcasting market and on DBS’s assumptions regarding competition in the broadcasting arena and the regulation which applies and which will apply to DBS’s operations and the restrictions which are imposed or will be imposed on DBS and its operations, taking into account the restrictions that apply and will apply to the Company, which affect DBS. However, the forecasts of DBS's management may not materialize because of changes in demand in the broadcasting market, fiercer competition in this field, the entry of additional entities into the broadcasting field or alternative fields and in light of the regulatory restrictions which are imposed or will be imposed on DBS or on its partnerships with the Company. Materialization of DBS’s goals in terms of more intense penetration of VoD services to its customers also depend on the availability of the types of decoders used to receive this service in customer homes and the Internet speed available in the subscriber's home (see Section 5.4). Increasing the penetration rates of PVR Decoders also depends on the availability of such decoders and the manufacturer’s supply dates.

5.22 Risk Factors

Following is a list of the threats, weaknesses and other risk factors of DBS (the **"Risks”**) attributable to the general environment, industry and special nature of its operations.

5.22.1 Macro risks

A. Financial risks – a material part of DBS's expenses and investments are linked to fluctuations in the exchange rate of the US dollar (particularly content, satellite segments, purchase of decoders and additional logistics equipment). Therefore, sharp fluctuations in the exchange rate will have a material effect on DBS's business results. In addition, the loans taken out by DBS from its shareholders and the debentures DBS issued are linked to the consumer price index and, therefore, sharp rises in inflation rates could have a material effect on DBS's business results.

B. Recession/economic downturn - A downturn in the economic, rise in unemployment and decline in disposable income may lead to a drop in the number of DBS subscribers, lower revenues for DBS and have a negative impact on its business results.

C. Security situation - An ongoing unstable security situation in large areas of Israel, which disrupts the day-to-day lives of the residents, could have an adverse effect on DBS's business results.

5.22.2 Sector risks

A. Dependence on licenses - DBS provides multi-channel television broadcasts in accordance with a broadcasting license and other licenses. A breach of the provisions of the licenses as well as of the law under which the licenses are issued could bring about, subject to the license conditions, the cancellation, amendment or suspension of the licenses and consequently material harm to DBS's ability to continue operating in the field.

B. Regulation - DBS's operations and broadcasts are subject to obligations and restrictions set out in legislation and to a system of licensing, oversight and approvals from various regulatory bodies, and consequently DBS may be influenced and restricted by policy considerations dictated by these entities and by their decisions and changes in communications legislation (see Section 5.17). The degree of regulatory intervention is very high and regulatory changes impact on DBS's operations and may cause have an adverse effect on its financial results. In addition, the operations of DBS, as a company supplying services to the public, is subject to consumer protection legislation.

C. Intense competition - The field of broadcasts is characterized by a very high penetration rate and intense competition, which requires DBS to constantly and continually invest in attracting and retaining customers, and dealing with high customer churn rates between DBS and HOT. For details about competition with HOT, see Section 5.7.

D. Development of new technologies - The risk in the development of new technologies is that they will render existing technology obsolete, which will force DBS to male large monetary investments to retain competitive standing. Alternatively, if new technologies are developed that enable entry into the field of multi-channel broadcasts without making heavy financial investments, the entry barriers into the field might be lowered and this will constitute a threat to DBS's competitive status (see Section 5.1.5A).

E. Deploying alternative multi-channel broadcast infrastructures - The DTT system activity and particularly the possibility of expanding it as well as the entry of additional players into the field of provision of video content over additional infrastructures or expansion of the existing services may negatively impact on the financial results of DBS.

F. Piracy - DBS is exposed to viewers' attempts to use pirate connections in order to receive DBS broadcasts without paying subscription fees and is exposed to public access to content to which DBS has the copyright.

G. Exposure to class action lawsuits - In view of the number of subscribers DBS and HOT have, there is exposure to class action lawsuits in material amounts. For information regarding pending applications against DBS for certification as class actions, see Section 5.20.

H. Accessibility to video content over the Internet - The Internet enables access to video content, including via file sharing software. Growth in this trend, may make it difficult for DBS to attract and retain customers, and offer its services.

5.22.3 Special risks of DBS

A. Need to receive approval from financing banks to conduct operations at DBS - Performance of operations and certain proceedings is dependent up receipt of prior approval from the Banks. This restriction could hinder DBS's operations (see Section 5.15.2).

B. Exposure to having credit called in for immediate repayment due to non-compliance with loan agreements - Failure of DBS to comply with the provisions of the Financing Agreement or with the provisions of the deeds of trust signed with the Trustee for the debenture holders may, in accordance with and subject to the provisions of each of said agreements, respectively, entitled the relevant lenders to a cause of action to call in all the credit provided to DBS for immediate repayment and realization of the securities given by DBS and its shareholders (see Section 5.15). Some DBS creditors are entitled to call their debt in for immediate repayment if other DBS debts are called in for immediate repayment (cross-default).

C. Restrictions that are the result of the ownership structure - DBS is restricted in cooperative ventures with the Company with respect to offering a basket of communications services that can compete with HOT in a manner that has a material impact on DBS's business status and is competitive ability (see Section 5.7.3**Error! Reference source not found.**). In the past, due to the Company's holdings in DBS, regulatory restrictions were imposed on it regarding the receipt of funds from its shareholders, which should it apply to DBS will reduce the sources of finance that could be available to it.

D. Existence of sufficient cash flow - DBS is required to maintain a cash flow which is sufficient for compliance with its business plan and with repayment of the credit it used. The absence of a sufficient cash flow may impact on the ability of DBS to increase its rate of penetration of advanced services (such as PVR and HDPVR decoders) and to make it more difficult for it to face the competitive threats in view of technological developments and consumption patterns in the field. Furthermore, failure to repay on time, as aforementioned, constitutes grounds for calling in the bank credit and debentures in for immediate repayment and redemption in accordance with and subject to the provisions and caveats in the Financing Agreement and deeds of trust, respectively.

E. Malfunction of and damage to satellite - DBS broadcasts through space segments on the Amos 2 and Amos 3 satellites stationed in identical points in space. Operational malfunction or damage to one of the satellites is liable to disrupt and reduce the scope of DBS's broadcasts, and such disruption and reductions are expected to be more significant in the event of a failure of AMOS 2. Nonetheless, the duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a malfunction in one of the satellites, it will be possible to broadcast most of DBS's channels via the existing space segments on the other satellite, and perhaps even via additional segments on the same satellite that might be made available to DBS, but not all the channels broadcast (for the agreement with Spacecom, see Section 5.18.1). DBS is not insured against loss of revenues caused by satellite malfunction.

DBS's estimate as aforesaid in this paragraph is forward-looking information. This estimate is based on the supply of space segments by Spacecom. This estimate might not be realized or might be realized to some or other extent if Spacecom does not provide DBS with alternative segments in the event of malfunction of either of the satellites, or DBS is not permitted to carry out the above-mentioned channel transfer.

F. Dependence on holders of rights in the space segments - DBS is materially dependent on Spacecom, as the exclusive holder of the rights and the sole provider of space segments used by DBS, which is also responsible for operation of the space segments (see Section 5.18.1).

G. Dependence on providers of software, equipment, content, infrastructure and services - DBS is dependent on certain providers of software, equipment, content and services, including broadcast encryption services (see Section 5.13). Failure to receive the products or services they provide could harm DBS's ability to function and results.

H. Dependence on use of internal wiring - DBS is dependent on the use of internal wiring in some subscriber homes, which is owned by HOT, and the use of which is performed in accordance with the administrative directives (see Section 5.17.12). If the administrative directives are cancelled, without an appropriate alternative arrangement that would allow one supplier to make use of the infrastructures of the other in subscriber homes, this would constitute a substantial barrier to DBS's subscriber recruitment.

I. Damage to broadcasting centers - Damage to a broadcasting center might cause a significant difficulty for continued broadcasts, however, the splitting of broadcasts into two broadcasting centers (Kfar Saba and Re'em Junction) reduces the risk involved if one sustains damage and improves the possibility that most of the broadcasts will survive. In the event of damage to one of the broadcasting centers, DBS will be able to continue broadcasting its main channels from the other broadcasting center (the Kfar Saba center is able to broadcast a larger number of channels that the secondary center at Re'em Junction). All the broadcasting centers have an identical encryption system and therefore backup is also available for the encryption system in the event of damage to one of the broadcasting centers.

DBS's estimate as aforesaid in this paragraph is forward-looking information. This estimate is based on the provision of backup services from the supplier with which DBS has an agreement in the event of damage to the Kfar Saba broadcasting center. This estimate might not be realized or might be realized to some or other extent if DBS is not permitted to receive such backup services.

J. Malfunction of DBS's computer systems - A significant malfunction in DBS's central computer systems is liable to harm its operational capability. DBS has a remote backup site, which is intended for activation and provision of partial computer services within a few hours in the event of malfunction, however, it will be impossible to implement certain of DBS's operational capacities without the proper operation of the central computer systems.

DBS's estimate as aforesaid in this paragraph is forward-looking information. This estimate is based on the functioning of the remote backup site. This estimate might not be realized or might be realized to some or other extent if this functioning is not enabled.

K. Technical inferiority and the inability to offer integrated services - DBS's technology is technically inferior to that of its competitors. This technical inferiority prevents DBS from providing telephony and Internet services, and various interactive services, including VOD, on its infrastructure, and requires it to purchase these services or to enter into cooperation agreements in order to provide such services to its customers.

L. Defects in the encryption system - DBS's broadcasts are based on the encryption of broadcasts transmitted via satellites and encrypted via smart cards that are installed in the decoders in subscribers' homes. Defects in the encryption system or a breach thereof could make it possible to view broadcasts without payment to DBS, thereby causing a reduction in revenues and a breach of the agreements between DBS and its content suppliers.

M. Lack of exclusivity on frequencies - The spectrum of frequencies used by DBS to transmit its broadcasts from the broadcasting satellites to the satellite dishes installed in subscriber homes, and which is allocated in accordance with the license from the Ministry of Communications, is defined as a frequency spectrum with a secondary allocation, such that an Israeli party that is allowed to make authorized primary use the frequency spectrum. If the owner of the primary allocation uses the aforementioned frequency spectrum, this may cause DBS broadcasts to suffer in terms of quality and/or availability of the broadcasts to its subscribers, which may negatively impact on the financial results of DBS. At the date of this report, to the best of DBS's knowledge, the primary allocation holder did not make use of said frequencies such that it caused real and/or lengthy disruptions to DBS broadcasts.

N. Disturbances to broadcasts - Since DBS's broadcasts are wireless transmissions from broadcasting centers to broadcasting satellites and from them to the receiver dishes in subscriber homes, the broadcast of wireless signals in the same frequency spectrum, whether or not they originate in Israel, and extreme weather conditions of heavy rain, hail or snow could cause disruptions to the quality and/or availability of the broadcasts provided by DBS to its subscribers and may cause material harm to its financial results.

5.22.4 **The** following table sets out the risk factors by nature and ranking according to impact, **as assessed by DBS management. Note that DBS's assessments below regarding the level of exposure of DBS to a risk factor reflects the level of impact of such a risk factor on the assumption that the risk factor is realized, and this does not express any assessment whatsoever not grant any weight whatsoever to the chances of the aforementioned realization. Likewise, the order of appearance of the risk factors above and below is not necessarily based on the risk inherent in each risk factor, or the probability of its occurrence:**

	Level of Effect		
	Major	**Moderate**	**Minor**
Macro risk			
Financial risks		X	
Recession / economic downturn			X
Security situation		X	
Sector risk			
Dependence on licenses		X	
Changes in regulation	X		
Fierce competition	X		
Development of new technologies	X		
Alternative infrastructures		X	
Piracy			X
Exposure to class action lawsuits		X	
Accessibility to video content over the Internet			X
Specific risk			
Need to receive approval from the financing banks for performance of DBS operations			X
Exposure to bank credit being called in for immediate repayment as a result of failure to comply with the financing agreements	X		
Restrictions caused by ownership structure	X		
Need for sufficient cash flow	X		
Satellite malfunction and damage	X		
Dependence on space segment supplier	X		
Dependence on suppliers of content, equipment and infrastructure	X		
Dependence on essential content suppliers		X	
Dependence on use of internal wiring		X	
Damage to broadcasting centers	X		
Malfunction of computer systems		X	
Technical inferiority and inability to offer integrated services		X	
Malfunction of encryption system	X		
Lack of exclusivity on frequencies		X	
Disruptions of broadcasts	X		

The information included in this Section 5.22 and the assessments of DBS regarding the impact of the risk factors on DBS's operations and business constitute forward-looking information as defined in the Securities Law. The information and estimates are based on data published by regulatory agencies, DBS assessments of the market situation and the structure of competition, and of possible developments in the market and the Israeli economy. Actual results may differ significantly from these assessments if a change occurs in one of the factors taken into account in making them.

March 7, 2011	
Date	Bezeq - The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:
Shaul Elovitch, Chairman of the Board of Directors
Avi Gabbay, Chief Executive Officer

Chapter B of the Periodic Report

Directors' Report on the State of the Company's Affairs for the year ended December 31, 2010

We respectfully present the Directors' Report on the state of affairs of "Bezeq" – The Israel Telecommunication Corp. Limited ("the Company") and the consolidated Group companies (the Company and the consolidated companies together: "the Group"), for the year ended December 31, 2010.

Since April 25, 2010 the financial statements of Walla! Communications Ltd. ("Walla") have been consolidated in the Group's financial statements (see Note 5 to the financial statements).

The Group reports on four main segments in its financial statements:

1) Domestic fixed-line communications

2) Cellular

3) International communications, internet and NEP services

4) Multi-channel television

It should be noted that the Company's consolidated financial statements also include an "Other" segment which comprises mainly internet services and portal operation (by means of Walla) and customer call center services (by means of Bezeq Online), This Other segment is not material at the Group level.

The profit from continuing operations in the reporting year amounted to NIS 2,442 million compared with NIS 2,162 million in the prior year. The year's results were affected primarily by a rise in the revenue from continuing operations and in revenue from other operations, net, as a result of the recording of capital gains and the fact that in the reporting year the Company did not decide to continue the early retirement plan (see Note 17D to the financial statements). The increase in operating and general expenses was moderated by primarily by a rise in operating and general expenses, financing expenses and part of the losses from associates.

In the prior year, profit for the year included the profit from the discontinued operation resulting from the termination of the consolidation of DBS Satellite Services (1998) Ltd. ("DBS"). Consequently, the profit for the prior year amounted to NIS 3,541 million compared with NIS 2,442 million in the reporting year.

A. Explanations of the Board of Directors for the state of the corporation's affairs, the results of its operations, its equity, cash flows and other topics

1. Financial position

A. The Group's assets at December 31, 2010 amounted to NIS 14.24 billion, compared with NIS 13.94 billion on December 31, 2009, of which NIS 5.61 billion (39%) are property, plant and equipment, compared with NIS 5.43 billion (39%) on December 31, 2009.

The rise in the Group's assets stemmed primarily from the consolidation of the assets of Walla with those of the Group (see Note 5 to the financial statements). The rise was moderated primarily by a decrease in the assets of the Group's principal segments as described below.

In the fixed-line domestic communications segment, total assets, without investment in associates remained unchanged compared with the prior year. A decline in receivables from the Group's companies and a decline in cash balances and deferred taxes was offset primarily by a rise in property, plant and equipment balances resulting from the deployment of the NGN system and by a rise in intangible asset balances.

In the cellular segment, assets decreased from NIS 4.99 billion on December 31, 2009 to NIS 4.89 billion at December 31, 2010. The decrease stemmed primarily from a decline in cash balances, financial assets held for trading, inventory, property, plant and equipment and intangible assets. The decrease was partly offset by an increase in customer balances mainly as a result of increased income from the sale of terminal equipment in installments.

In the international communication, internet and NEP services segment, assets decreased from NIS 1,106 million on December 31, 2009 to NIS 1,038 million on December 31, 2010. Most of the decrease occurred in an investment in affiliates following the transfer to the Company of the holding in Walla and in cash balances as a result of the distribution of dividends. The decrease was partly offset primarily by an increase in the balance of property, plant and equipment.

In the multi-channel television segment there was an increase in total assets, from NIS 1,206 million on December 31, 2009 to NIS 1,243 million at December 31, 2010, which stemmed mainly from an increase in broadcasting rights and in intangible asset balances.

B. The Group's debt to financial institutions and debenture holders at December 31, 2010 amounted to NIS 5.7 billion, compared with NIS 4.14 billion on December 31, 2009. The increase stemmed primarily from the domestic fixed-line communications segment following the receipt of loans from banking corporations (see Note 14 to the financial statements). The increase was moderated by the repayment of debentures in the domestic fixed-line communications segment and the repayment of debentures and loans in the cellular segment.

2. Results of operations

A. Principal results

The Group's revenue in 2010 amounted to NIS 11.99 billion, compared with NIS 11.52 billion in the prior year, an increase of 4%. Most of the increase stemmed from the cellular segment. There was also an increase in the Group's revenue from the entry into consolidation of Walla! ("Other" segment) and an increase in income of the international communication, internet and NEP services segment which was moderated by a decrease in the domestic fixed-line communications segment.

The Group's depreciation and amortization expenses in 2010 amounted to NIS 1,409 million compared with NIS 1,485 million in the prior year, a decrease of 5%. Most of the decrease stemmed from the domestic fixed-line communications segment.

In 2010 the Group's salary expenses amounted to NIS 2,024 million compared with NIS 1,990 million in the prior year, an increase of 1.7%. The increase stemmed mainly from the entry into consolidation of Walla! Conversely, the increase was moderated in the reporting year by a decline in salary expenses in the domestic fixed-line communications segment and in the cellular segment.

The Group's operating and general expenses in 2010 amounted to NIS 5,026 million compared with NIS 4,871 million in the prior year, an increase of 3.2%. The increase stems primarily from a rise in the cellular segment. There was also an increase in expenses following the entry into consolidation of Walla! and an increase in the international communications, internet and NEP services segment. The increase was moderated by a decrease in expenses in the domestic fixed-line communications segment.

Other operating expenses, net, amounted to NIS 216 million compared with NIS 201 million in the prior year. Most of the change stemmed from the domestic fixed-line communications segment. There was also an increase in the international communications, internet and NEP services segment.

Financing expenses, net, in the reporting year amounted to NIS 109 million, compared with NIS 31 million in the prior year. The increase in financing expenses, net stemmed primarily from the domestic fixed-line communications segment. Moreover, in the prior year income was recorded from the realization of an investment in a venture capital fund (Stage One).

The Group's share in the losses of associates accounted by the equity method amounted to NIS 261 million in the reporting year compared with NIS 34 million in the prior year. As a result of the termination of the consolidation of DBS's statements in the prior year, the Company's share in DBS's losses amounted to NIS 92 million classified in the discontinued operations item. The balance of the increase was caused by a rise in the Company's share of the losses stemming from the increase in DBS's loss in the reporting year and the manner of their attribution to DBS's shareholders.

B. Operating segments

Below are operations data by segment presented in accordance with the Group's operating segments:

Revenue by operating segment	1-12/2010		1-12/2009	
	NIS millions	% of total revenue	NIS millions	% of total revenue
Domestic fixed-line communications	5,263	43.9%	5,303	46%
Cellular	5,732	47.8%	5,376	46.7%
International communications, Internet and NEP services	1,380	11.5%	1,318	11.4%
Multi-channel television services	1,583	13.2%	1,530	13.3%
Other and offsets(*)	(1,971)	(16.4%)	(2,008)	(17.4%)
Total	11,987	100%	11,519	100%

* The offsets are mainly for a segment which is an affiliate.

Operating profit by operating segment	1-12/2010		1-12/2009	
	NIS millions	% of total revenue	NIS millions	% of total revenue
Domestic fixed-line communications	2,043	38.8%	1,523	28.7%
Cellular	1,383	24.1%	1,190	22.1%
International communications, Internet and NEP services	320	23.2%	261	19.8%
Multi-channel television services	178	11.2%	248	16.2%
Other and offsets(*)	(180)		(250)	
Total	3,744	31.2%	2,972	25.8%

* The offsets are mainly for a segment which is an affiliate.

Domestic fixed-line communications segment

Revenue:

Revenue in 2010 amounted to NIS 5,263 million compared with NIS 5,303 million in the prior year, a decline of 0.8%.

The decline in the segment's revenue stemmed mainly from a decrease in revenue from interconnect fees to the cellular networks compared with the prior year (with a concurrent decrease in the expense).

There was also a decline in telephony revenues resulting from a decline in the number of lines and in call traffic which was moderated by the increase in revenue from internet and data transmission.

Costs and expenses:

Depreciation and amortization expenses in 2010 amounted to NIS 690 million compared with NIS 794 million in the prior year, a decrease of 13.1%. The decrease stemmed from the end of the depreciation of property, plant and equipment and a change in the scrap value of property, plant and equipment. The decline in depreciation was partly offset by an increase in depreciation stemming from investments in the NGN project.

Salary expenses in 2010 amounted to NIS 1,079 million compared with NIS 1,094 million in the prior year, a decrease of 1.4%. The decrease in salary expenses stemmed primarily from a rise in the salary attributed to investment, a decline in actuarial costs and a decline in the number of employees. This decline was offset almost completely by an ongoing increase in salary and special bonus granted in accordance with a collective agreement.

Operating and general expenses in 2010 amounted to NIS 1,609 million compared with NIS 1,690 million in the prior year, a decrease of 4.8%. The decrease stemmed primarily from an application of efficiency measures, a decline in output prices and a decline in interconnect fees to the cellular networks (combined with a decline in revenue from interconnect fees, as aforesaid).

Other operating expenses, net in 2010 amounted to NIS 158 million compared with NIS 202 million in the prior year. The increase in expenses stemmed primarily from an increase in capital gains from the sale of copper assets, a decline in retirement expenses for early retirement severance pay (see Note 17D to the financial statements) and a decline in provisions for legal claims.

Profitability:

Operating profit in the segment in 2010 amounted to NIS 2,043 million compared with NIS 1,523 million in the prior year, an increase of 34%. The improvement in operating profit stems primarily from the transition from other operations, net in the prior year to revenue in the current year, and from the above-mentioned changes in the expenses and income item.

Financing expenses, net

Financing expenses, net in the segment in the reporting year amounted to NIS 90 million, compared with financing expenses, net of NIS 15 million in the prior year. The change stems primarily from a decline in revenues from hedging transactions against the CPI which stemmed from a decline in the financial value of the hedging transactions and in the rate of increase of the CPI, a decline in financing revenues from shareholder loans to DBS and the increase in fixed and variable shekel interest credit. Conversely there was a decline in linkage differential expenses and interest for debentures as a result of a decline in the rate of the CPI and a decline in the volume of CPI-linked liabilities.

Cellular segment

Revenue:

In 2010 revenue in the segment amounted to NIS 5,732 million compared with NIS 5,376 million in the prior year, an increase of 6.6%. Revenues in the services segment in the period amounted to NIS 4,550 million compared with NIS 4,256 million in the prior year, an increase of 6.9%. The increase in the services segment stemmed from an increase in the number of subscribers and an increase in per-user revenue, most of which stemmed from an increase in revenue from content and roaming services and call completion fees.

Revenue from the sale of terminal equipment in the period amounted to NIS 1,182 million, compared with NIS 1,120 million in the prior year, an increase of 5.5%. The increase stemmed primarily from a rise in terminal equipment prices.

Costs and expenses:

Depreciation and amortization expenses in 2010 are similar to those of the prior year and amounted to NIS 601 million compared with NIS 603 million in the prior year, an increase of 0.3%.

Salary expenses in 2010 amounted to NIS 590 million compared with NIS 601 million in the prior year, a decrease of 1.8%. The decrease in salary expenses stemmed primarily from an increase in salaries capitalized for investment and a decrease in the expenses for the share-based payment plan for managers.

Operating and general expenses in 2010 amounted to NIS 3,158 million compared with NIS 2,982 million in the prior year, an increase of 5.9%. The increase stemmed primarily from a rise in service costs together with a rise in revenues from services (mainly the costs of call completion and roaming fees), an increase in transmission, site rental and maintenance expenses, and an increase in doubtful debt expenses which were partly offset by a decrease in advertising expenses

Profitability:

Operating profit in the segment in 2010 amounted to NIS 1,383 million compared with NIS 1,190 million in the prior year, an increase of 16.2%. The improvement in operating profit stems from the changes described above in the income and expense items.

Financing expenses, net

Financing expenses, net amounted in 2010 to NIS 11 million compared with NIS 10 million in the prior year. The increase stems from interest and linkage in the third quarter, amounting to NIS 49 million for a court judgment (see Note 18F to the financial statements) which was mostly offset by a decline in interest and loan revaluation expenses and an increase in revenues from rate differentials, net.

International communications, internet and NEP segment

Revenue:

In 2010 revenue in the segment amounted to NIS 1,380 million compared with NIS 1,318 million in the prior year, an increase of 4.7%. The increase in revenue stems primarily from an increase in internet revenue resulting from a rise in the number of customers, an increase in operations in the integration sector (IT solutions and communications for businesses) and from call transfer operations among communications operators worldwide. Conversely there was a decline in revenues from outgoing traffic minutes which stems from a decline in the volume of traffic and a decline in revenues from incoming traffic minutes.

Costs and expenses:

Depreciation expenses in 2010 amounted to NIS 94 million compared with NIS 84 million in the prior year, an increase of 12%. The increase stems from amortization of capacity usage rights, development costs and subscriber acquisition costs.

Salary expenses in 2010 amounted to NIS 248 million compared with NIS 242 million in the prior year, an increase of 2.5%.

Operating and general expenses in 2010 amounted to NIS 781 million compared with NIS 731 million in the prior year, an increase of 6.8%. The increase in expenses comes together with an increase in revenues in the segment.

Other operating income, net in the reporting year included the posting of capital gains amounting to NIS 57 million which stemmed from recording the Company's holdings in Walla! at market value before they gained control, (see Note 5 to the financial statements).

Profitability:

Operating profit in the segment in 2010 amounted to NIS 320 million compared with NIS 261 million in the prior year, an increase of 22.6%. The improvement in operating profit stems from the changes described above in the income and expense items.

Multi-channel television segment (accounted by the equity method)

Revenue:

Revenue in the segment in 2010 amounted to NIS 1,583 million compared with NIS 1,530 million in the prior year, an increase of 3.5%. The increase in revenue stemmed mainly from a rise in revenue from the premium channels, a rise in the consumption of advanced products and an increase in the number of subscribers.

Costs and expenses:

The cost of sales in 2010 amounted to NIS 1,129 million compared with NIS 1,042 million in the prior year, an increase of 8.3%. The increase in the cost of sales stems primarily from the differential for copyright to Acum, an increase in the costs of the premium channels and amortization expenses.

Sale, marketing and administrative and general expenses amounted to NIS 276 million, compared with NIS 240 million in the prior year, an increase of 15%. The increase in expenses stems primarily from an increase in amortization and salary expenses.

Profitability:

Operating profit in the segment in 2010 amounted to NIS 178 million compared with NIS 248 million in the prior year, a decrease of 28.2%. The decrease in operating profit stems from the above-mentioned changes in the expenses and income items.

C. Income tax

The Group's tax expenses in the reporting year amounted to NIS 932 million, representing 27.6% of pre-tax profit, compared with NIS 807 million in the prior year, representing 27.2% of pre-tax profit. The effective tax rate in the current year is higher as a result of the Group’s share in the losses of associates which are not recognized for tax purposes. The increase in the effective tax rate was partly offset by a fall in the corporation tax rate compared with the prior year.

D. Main data from the Group's consolidated income statements (in NIS millions)

	Q1 2010	Q2 2010	Q3 2010	Q4 2010	2010	2009	Increase (Decrease)	%
Ongoing operations								
Income	2,915	2,981	3,033	3,058	11,987	11,519	468	4%
Costs and expenses	2,041	1,991	2,054	2,157	8,243	8,547	(304)	(4%)
Operating profit	874	990	979	901	3,744	2,972	772	26%
Financing income (expenses) net	22	(35)	(74)	(22)	(109)	31	(140)	-
Profit after financing income (expenses), net	896	955	905	879	3,635	3,003	632	21%
Equity in profits (losses) of associates	(23)	(86)	(71)	(81)	(261)	(34)	(227)	668%
Profit before income tax	873	869	834	798	3,374	2,969	405	14%
Income tax	231	231	246	224	932	807	125	15%
Profit for the year from ongoing operations	642	638	588	574	2,442	2,162	280	13%
Profit (loss) for the period from discontinued operation	-	-	-	-	-	1,379	(1,379)	-
Profit for the period	642	638	588	574	2,442	3,541	(1,099)	(31%)
Attributable to:								
The Company's equity holders	642	638	588	575	2,443	3,603	(1,160)	(32%)
Non-controlling interest	-	-	-	(1)	(1)	(62)	61	(98%)
Profit for the period	642	638	588	574	2,442	3,541	(1,099)	(31%)
Earnings per share								
Basic earnings per share (in NIS)								
Earnings from ongoing operations	0.24	0.24	0.22	0.21	0.91	0.82	0.09	11%
Earnings from discontinued operations	-	-	-	-	-	0.55	(0.55)	-
	0.24	0.24	0.22	0.21	0.91	1.37	(0.46)	(34%)
Diluted earnings per share (in NIS)								
Earnings from ongoing operations	0.24	0.24	0.22	0.20	0.90	0.80	0.1	13%
Earnings from discontinued operations	-	-	-	-	-	0.54	(0.54)	-
	0.24	0.24	0.22	0.20	0.90	1.34	(0.44)	(33%)

Comparison of 2010 fourth quarter results with the results of the third quarter

Details of the material changes:

Total costs and expenses increased in the fourth quarter by NIS 103 million compared with the prior quarter. Most of the increase stems from the domestic fixed-line communications segment, as a result of a rise in salary expenses caused primarily a special bonus awarded on the basis of a collective agreement as well as a rise in operating and general expenses. There was also a rise in the cellular segment stemming mainly from an increase in expenses for the purchase of terminal equipment.

3. Equity

Equity attributed to the Company's controlling shareholders at December 31, 2010 amounted to NIS 5.33 billion, accounting for 37.4% of the total balance sheet, compared with NIS 6.54 billion at December 31, 2009 which constituted 47% of the total balance sheet. The decrease in equity stemmed from the timing of the recording of distribution of a dividend from the profits of the prior year.

4. Cash flows

Consolidated cash flow for 2009 includes the cash flow from the operations of DBS through August 20, 2009. The consolidated cash flow for 2010 is not included in this operation

Consolidated cash flows generated by operating activities in 2010 to NIS 3,696 million, compared with NIS 3,916 million in the prior year, a decrease of NIS 220 million. Most of the decrease stems from the termination of the consolidation of the statements of DBS. (In the corresponding period the cash flow of DBS from ongoing operations of NIS 260 million was included). There is also a rise in the cash flow from ongoing operations is the cellular segment which was offset by a decline in the cash flow from ongoing operations in the domestic fixed-line communications segment and in the international communications, internet and NEP segment. The decline in the cash flow from ongoing operations was caused mainly by payments for early retirement, payment to suppliers and tax payments. The decline was moderated primarily by a rise in earnings from ongoing operations and an increase in trade receivables.

Cash flow generated by ongoing operations is one of the sources of financing for the Group's investments, which during the reporting year included NIS 1,279 million invested in the development of communications infrastructures and NIS 343 million in intangible assets and deferred expenses, compared with investments amounting to NIS 1,363 million and NIS 349 million, respectively, in the prior year. Furthermore, NIS 115 million net was used for Walla's acquisition of shares in Korel Tal Ltd. (which operates the Yad2 website), in addition to NIS 30 million which was used to acquire Walla shares. Conversely, a net consideration from the sale of financial assets held for trading of NIS 138 million was received compared with an investment of NIS 134 million in the prior year.

In the reporting year, the Group repaid debts and paid interest totaling NIS 1,382 million, of which NIS 697 million for debentures, NIS 448 million of loans, and NIS 237 million of interest payments. This compares with repayment of a net debt and interest payments of NIS 1,145 million in the prior year. In contrast, the Group received long-term loans of NIS 2,670 million and NIS 26 million in proceeds from the exercise of stock options for employees. This compares with the receipt of loans of NIS 400 million, short-term credit of NIS 48 million and NIS 129 million in proceeds from the exercise of stock options for employees in the prior year. Most of the cash flows for financing operations stemmed from the domestic fixed-line communications segment.

In the reporting year, a cash dividend of NIS 3,733 million was paid, compared with NIS 1,941 million in the prior year.

The monthly average of long-term liabilities to financial institutions and debenture holders in 2010 amounted to NIS 5,079 million.

Average credit from suppliers in the reporting year was NIS 1,010 million and the average short-term customer credit was NIS 2,672 million. The average long-term customer credit was NIS 925 million.

The working capital deficit of the Group at December 31, 2010 amounted to NIS 93 million, compared with a working capital surplus of NIS 10 million on December 31, 2009. The Company has a working capital deficit at December 31, 2010 of NIS 1,208 million, compared with a working capital deficit of NIS 769 million in the prior year. The increase in the Company's working capital deficit stems primarily from an increase in short-term financial and other liabilities and a decrease in current assets. The increase in the Group's deficit was moderated by an improvement in working capital in the cellular segment.

The Board of Directors of the Company reviewed the Company's projected cash flows, including sources of credit and credit-raising options, and determined that despite the working capital deficit, the Company does not have a liquidity problem. The Board reviewed existing cash sources and requirements as projected for the foreseeable future, (including as a result of the expected capital reduction if and when this is approved by the court), it reviewed the Company's investment requirements, and it also examined the potential sources of finance and scope of recruitment available to the Company, taking into account existing and anticipated credit ratings (including as a result of the above-mentioned capital reduction). The Company relied, inter alia, on significant sources of cash flow originating from its subsidiary, Pelephone, in the form of regular dividend distributions. Based on a review of all these factors, the Board concluded that the Company has substantial ability to comply with existing and projected cash requirements in the foreseeable future, both by creating cash from operations and by its ability to raise significant volumes of debt from banking and non-banking sources.

The above information includes forward-looking information based on the Company's liquidity assessments. Actual results might differ significantly from the above assessments if there is a change in one of the elements on which they are based.

5. Explanations of the Board of Directors relating to exposure to market risks and their management (Part B below)

The Company operates on the basis of a financial exposure policy adopted by the Company's Board of Directors on June 26, 2008 (see Part B below).

Below are summaries of the sensitivity test tables shown in part B.

Sensitivity to changes in the USD/NIS exchange rate

2010	**Profit (loss) from changes**		**Fair value assets (and liabilities)**	**Profit (loss) from changes**	
	10%	5%	At a dollar rate of 3.549	-5%	-10%
Total	(78)	(41)	(787)	41	78

2009	**Profit (loss) from changes**		**Fair value assets (and liabilities)**	**Profit (loss) from changes**	
	10%	5%	At a dollar rate of 3.775	-5%	-10%
Total	(116)	(57)	(1,206)	58	116

Surplus liabilities exposed to changes in the dollar exchange rate declined by NIS 419 million primarily as a result of a decline in liabilities to suppliers.

Sensitivity to changes in the CPI

2010	**Profit (loss) from changes**			**Fair value assets (and liabilities)**	**Profit (loss) from changes**		
	1.5%	0.2%	0.1%		-0.1%	-0.2%	-1.5%
Total	(40)	(4)	(3)	(2,964)	3	4	40

2009	Profit (loss) from changes			Fair value assets (and liabilities)	Profit (loss) from changes		
	1.5%	0.2%	0.1%		-0.1%	-0.2%	-1.5%
Total	(51)	(6)	(3)	(3,814)	3	6	51

Surplus liabilities exposed to changes in the CPI declined by NIS 850 million primarily as a result of the Group's repayment of CPI-linked debentures.

Sensitivity to changes in real shekel interest

2010	Profit (loss) from changes			Fair value assets (and liabilities)	Profit (loss) from changes		
	16%	10%	5%		-5%	-10%	-16%
Total	(108)	(69)	(36)	(1,907)	37	74	122

2009	Profit (loss) from changes		Fair value assets (and liabilities	Profit (loss) from changes	
	10%	5%		-5%	-10%
Total	(56)	(27)	(2,768)	29	63

Surplus liabilities exposed to changes in the real shekel interest declined by NIS 861 million primarily as a result of the Group's repayment of debentures.

Sensitivity to changes in nominal shekel interest

2010	Profit (loss) from changes			Fair value assets (and liabilities)	Profit (loss) from changes		
	16%	10%	5%		-5%	-10%	-16%
Total	32	20	10	616	(10)	(20)	(34)

2009	Profit (loss) from changes			Fair value assets (and liabilities)	Profit (loss) from changes		
	12%	10%	5%		-5%	-10%	-16%
Total	(7)	(6)	(3)	(1,606)	3	7	7

The surplus assets exposed to changes in the nominal shekel interest declined by NIS 990 million as a result of raising of NIS 2.6 billion of debt via a number of loans from Israeli banks in 2010, NIS 400 million of which was against the early repayment of bank loans taken in March 2009, as described in Note 14 B to the financial statements.

Sensitivity to changes in the dollar interest rate

On December 31, 2010 the Group's exposure to changes in the dollar interest rate is negligible.

6. The link between the remuneration awarded under Article 21 and the contribution made by the recipient of the remuneration to the Corporation

In a meeting held by the Board of Directors on March 7, 2011, there was a discussion of the terms of service and remuneration of the Company's officers and interested parties which are described in Section 7 of Chapter D of the Periodic Report pursuant to Article 21 of the Regulations for Periodic and Immediate Reports, 1970 (the "Regulations for Periodic and Immediate Reports"). The Board discussed the link between the amounts of remuneration paid in 2010 to each of the senior officers and interested parties in the Company and their actions and contribution to the Company in 2010. For the purpose of the discussion which took place in March 2011 the data relevant to the terms of employment of each officer and interested party were presented to the Board members in advance.

It should also be noted that in a Board meeting which took place on December 30, 2010 the Board held a wide-ranging discussion of all the terms of employment of Bezeq's CEO, Mr Avi Gabbay, Pelephone's CEO, Mr Gil Sharon and Bezeq International's CEO, Mr Yitzhak Benvenisti in order to approve changes in these terms as of 2011, as described in the Immediate Report published by the Company on January 3, 2011. Prior to this discussion, a number of discussions were held by the Remuneration Committee and Audit Committee in which they discussed at length the contribution and remuneration package of each of the above three officers as a whole.

The Board noted that the remuneration paid to each of the Group's senior officers was set, inter alia, while taking into account the position in the Group held by each one and his contribution to the Group and its operations, on the basis of the Company's remuneration plan for 2010 which was approved in advance in December 2009 by the Board, in relation to Avi Gabbay, Gil Sharon, Yitzhak Benvenisti and Alan Gelman.

The Board reviewed comparison data using a comparison survey prepared by Prof. Moshe Zviran (the "Zviran Survey") of customary bonus levels for the positions of chairman of a board of directors, CEO, deputy CEO and vice presidents, as applicable, in companies similar to the Company. It also discussed additional parameters in order to examine the reasonableness and fairness of the remuneration in relation to officers in the Company. These parameters included significant management targets achieved in the period of the report and the existence of one-off events which are likely to affect the targets set in the remuneration plan determined for the officer.

The Board believes that the remuneration of each of the managers as set forth in Article 21 of Chapter D of the Periodic Report (Additional details about the Corporation), which also includes the bonuses based on the results of the Company or its subsidiaries, as applicable, reflects the contribution made by the above officers to the Group, and is fair and reasonable, as specified below[1]:

The five best-remunerated officers in the Corporation

A. Mr Abraham Gabbay- CEO Bezeq

In its examination of the remuneration paid for 2010 to Mr Gabbay, the Board noted the Company's achievements in various fields under his management, its extremely successful compliance with the EBITDA target (separate) set in its work plan, his success in expanding its operations in the internet sector as well as in implementing overall efficiency measures.

Approval for the annual bonus paid in 2010 to Mr Gabbay was based on the rate of his compliance with the targets set by the Board in the 2010 bonus plan which was approved in December 2009 – exceeding the EBITDA target based on the Company's (separate) financial statements for 2010 and compliance with the targets relating to the pace of progress in its NGN network construction project. The Board also decided to award him an additional sum in excess of the formula set in the bonus plan, at its discretion. The amount of the additional bonus was approved as a token of appreciation for Mr Gabbay's achievements in 2010, in light of the above-mentioned achievements of the Company. The additional amount was approved by the Company's Remuneration Committee and Audit Committee, prior to the Board discussion..

The Board found that the remuneration paid to Mr Gabbay for 2010 is within the range of remuneration presented in the Zviran Survey, in the upper section of the range. It should be noted that Mr Gabbay's remuneration, which was reviewed in the survey, did not include the retention bonus paid to him following the changes which took place in the control of the Company in the reporting period. This bonus is a one-off exceptional payment[2].

The board of directors believes that the remuneration paid to the company's CEO for 2010 is reasonable and fair in the circumstances, given the size of the Company, the scope of its operations and the complexity of his position as its CEO.

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[1] For additional details of the remuneration paid to senior officers, see also Note 30 to the financial statements for 2010 and Article 21 (Section 7) in Chapter D of the Periodic Report.

[2] On the date of approval of the above-mentioned bonus, the Audit Committee and the Board determined that the retention plan does not deviate from other retention plans in the market, based, inter alia, on the comparison work carried out on other retention plans by Prof. Zviran at the same time. For details, see the Immediate Report on the adoption of retention plans for senior managers in the Bezeq Group dated December 31, 2009.

B. Gil Sharon – CEO of Pelephone

In its examination of the remuneration paid for 2010 to Mr Sharon, the Board noted his key achievements in that year, chief among which were his leadership of Pelephone to very good operating and financial results, continuation of the reinforcement and strengthening of its position in the cellular telephone market, implementation of changes and efficiency measures in the second half of the year in order to apply and assimilate the new regulatory conditions applicable to cellular companies from 2011, and also compliance with additional significant management targets.

Approval of the annual bonus for 2010 to Mr Sharon is based on his compliance with the EBITDA target (based on Pelephone's financial statements for 2010), a target set in the 2010 bonus plan which was approved in December 2009, while in respect of the review of compliance with the EBITDA target, the negative effects of one-off provisions for events which took place in the 1990s and which led to a legal proceeding which took place in 2000 were neutralized.

The Board also agreed to award him an additional sum in excess of the formula set in the bonus plan, at its discretion. The amount of the additional bonus was approved as a token of appreciation for Mr Sharon's above-mentioned achievements as Pelephone's CEO in 2010. The additional amount was approved by the Company's Remuneration Committee and Audit Committee, prior to the Board discussion.

The Board found that the remuneration paid to Mr Sharon for 2010 is within the range of remuneration presented in the Zviran Survey, in the upper section of the range. It should be noted that Mr Sharon's remuneration, which was reviewed in the survey, did not include the retention bonus paid to him following the changes in the control of the Company which took place in the reporting period. This bonus is a one-off exceptional payment[3].

The Board believes that the remuneration paid to the Pelephone's CEO for 2010 is reasonable and fair in the circumstances, given the size and scope of Pelephone's operations and the complexity of his position as its CEO.

C. Mr Shlomo Rodav – chairman of the previous board of directors

In its review of the remuneration paid to Mr Rodav for 2010, the Board noted that in that year, Mr Rodav continued to lead the Group and brought it to record profitability, while increasing the Group's revenues and creating value for shareholders, despite the fierce competition and regulatory restrictions in the markets in which the Group's companies operate. The Group also noted that in the reporting year Mr Rodav led a number of infrastructure projects simultaneously, such as the international submarine cable, promotion of the NGN project and reinforcement of Pelephone's new network. Mr Rodav created an effective work environment with the Group's managers and the work of the Board and its committees, and the boards of the subsidiaries of which Mr Rodav served as chairman, were managed efficiently, thoroughly and properly. Moreover, Mr Rodav also managed the process of changes in the control in the Company as well as the ensuing changes in the other boards, efficiently and properly in a manner which contributed greatly to its stability. The Board found that the remuneration set for Mr Rodav for 2010[4] is in excess of the range presented in the Zviran Survey, but in view of his above-mentioned achievements and the Group's performance and given the size of the Group and the complexity of its operations when compared with other companies in the Israeli market, the Board believes that the amount is reasonable and fair under the circumstances.

D. Alan Gelman – Deputy CEO and CFO of Bezeq

In its review of the remuneration paid for 2010 to Mr Gelman, the Board noted the Company's compliance with the EBITDA target which exceeded the Company's targets in its work plan, Mr Gelman's success in investor relations and the complexity of his role. Approval of the 2010 annual bonus for Mr Gelman is based on (1) the targets set in the 2010 bonus plan which was approved in December 2009; the EBITDA target based on the Company's separate financial statements for 2010, investor relations targets, management of cash flow and other management targets. (2) an additional sum in excess of the formula set in the bonus plan, at the Board's discretion.. The amount of the additional bonus was approved as a token of appreciation of Mr Gelman's achievements in 2010 in

[3] See footnote 3.

[4] In its discussions regarding Mr Rodav the Board referred to the sum of the bonus approved by the Board which amounted to 18 monthly salaries, the payment of which is conditional upon the approval of the general meeting and will be paid after its meeting if it is approved.

light of the Company's achievements and in particular the excellent rate of compliance with the EBITDA target. The total annual bonus paid to Mr Gelman equals 80% of his annual salary.

The Board found that the remuneration paid to Mr Gelman for 2010 is above the range presented in the Zviran Survey, but in view of the above-mentioned achievements and the Group's performance, and given the size of the Group and the complexity of its operation, the Board believes that the amount is reasonable and fair in the circumstances.

E. Mr Yitzhak Benvenisti, CEO Bezeq International

In its review of the remuneration paid for 2010 to Mr Benvenisti, the Board noted his key achievements in that year, among them the finding of new areas of growth despite the decline in the international call sector (international carrier), the preservation of Bezeq International as the largest player in its sector despite difficult market conditions and Mr Benvenisti's success in managing the submarine cable tender and the agreement with the supplier for the placing of the cable.

Approval of the 2010 annual bonus for Mr Benvenisti is based on (1) compliance with the EBITDA target based on the 2010 financial statements of Bezeq International, which was set in the Company's 2010 bonus plan which was approved in December 2009. For the purpose of reviewing compliance with this target, "Other income" stemming from the Walla! Communication Ltd. share sale transaction was neutralized; (2) an additional sum in excess of the formula set in the bonus plan, was set at the Board's discretion. The additional amount was approved as a token of appreciation of Mr Benvenisti's achievements in 2010, as explained above. The additional amount was approved by the Company's Remuneration Committee and Audit Committee, prior to a discussion in the Board.

The Board found that the remuneration to Mr Benvenisti for 2010 is within the range of remuneration presented in the Zviran Survey, in the upper section of the range. It should be noted that Mr Benvenisti's remuneration, which was reviewed in the survey, did not include the retention bonus paid to him following the changes which took place in the control of the Company in the reporting period. This bonus is a one-off exceptional payment[5].

The Board believes that the remuneration paid to Mr Benvenisti for 2010 is reasonable and fair in the circumstances, in light of his above-mentioned achievements.

Remuneration to interested parties in the Company

Management agreement with Eurocom Communication Ltd. ("Eurocom Communication")

The details of the management agreement with Eurocom Communication and the services it has provided to the Company since the date of the change in control in the Company (April 14, 2010)[6] were reviewed for the board of directors by Messrs. Shaul Elovitch, Or Elovitch, Amikam Shorer and Reuben Sgan-Cohen.

Also presented to the board of directors were comparative data based on a comparative survey prepared by Ernst & Young – Kost, Forer, Gabbay and Kasierer, relating to management agreements in other public companies of similar size, or as close as possible to similar size, to the Company, given the difficulty in finding companies with a market value similar to that of the Company.

The Board members discussed the scope and nature of the services which had been provided by Eurocom Communication in the reporting year (commencing on the date of change in control of the Company), and which included, inter alia, consultancy in various areas, chief of which are advice to the Group and group strategy, regulation, finance, taxation and real estate. The advice was given in regular work meetings and reviews of various topics and discussions outside the regular meetings. Moreover, pursuant to the provisions of the management agreement, in the reporting year, the Company did not pay remuneration to the directors for their service as directors, except for the previous chairman of the board, external directors and independent directors.

[5] See footnote 3.

[6] The details of the management agreement are presented in Section 7 of Chapter D of the Periodic Report. It should be noted that in accordance with the terms of the management agreement, the consideration paid to Eurocom Communication in the reporting year for management services is for the period commencing June 1, 2010, even though in actual fact services were provided from April 14, 2010. The commitment to the management agreement was approved pursuant to Section 275 of the Companies Law by the general meeting of the Company on June 10, 2010.

The members of the Board found that the remuneration paid in 2010 to Eurocom Communication under the management agreement is reasonable and fair given the contribution made by this agreement to the Company, based on the following reasons:

The consultancy services by virtue of the management agreement were provided by professional entities with much experience and expertise in the communication market and in the Company's areas of operations, including in the areas of regulation and finance as well as real estate. These entities invested substantial work time in providing these services in the reporting year (and this was in addition to the hours invested by some of them by virtue of their service as directors in the Company, and in the Group's subsidiaries and associates).

The contribution of the consultancy services to the Company in its preparation for the regulatory changes confronting it, was significant.

In the period commencing on the date of the changes in control of the Company, remuneration was not paid to the directors: Shaul Elovitch (who since the beginning of 2011 serves as chairman of the Company's board of directors), Or Elovitch, Orna Elovitch-Peled, Amikam Shorer, Felix Cohen and Eliahu Holtzman for their service as directors in the Company and in the Company's subsidiaries and/or associates. The cost of director remuneration saved by the Company in relation to the service of these directors in the period of the agreement (calculated in terms of the remuneration paid by the Company to the external directors and independent directors) amounts to a significant proportion of the remuneration paid to Eurocom Communication in the reporting period under the management agreement.

The comparison data presented to the members of the board of directors in the E&Y Survey reveal that, compared with other companies of similar or almost similar size to the Company, the remuneration under the management agreement is lower than average.

Employee directors

It should be noted that the Company's board of directors did not hold a discussion as set forth in Article 10(B)(4) of the Articles for Periodic and Immediate Reports of the reasonableness and fairness of the remuneration paid to the employee directors, Messrs Rami Nomkin and Yehuda Porat since the remuneration paid to them is by virtue of their positions as Company employees and in accordance with their employment agreements, and not by virtue of their service as Company directors.

B. Exposure to and management of market risks

Responsibility for management of the Company's market risks

The person responsible for management of the Company's market risks is Deputy CEO and CFO, Alan Gelman. For details of his education and experience, see Section 15(c) in Chapter D of the Periodic Report.

Market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, the CPI, inflation, prices of raw materials and equipment.

The Company acts in accordance with a financial exposure management policy adopted by the Board of Directors of the Company on June 26, 2008. Pursuant to that policy, the Company implements partial hedging operations depending on the circumstances and its own judgment, primarily in order to reduce its exposure to changes in the CPI, in the price of copper and in foreign currency exchange rates. The Company monitors the Group's exposure management every month, and this includes, where necessary, recommending changes in exposure management. In cases where management considers that a deviation from this policy is necessary, its recommendations are brought before the Company's Board.

Inflation – The Company has a significant surplus of liabilities over CPI-linked assets, and the bulk of its financial exposure stems from the risk of a rise in inflation. The rate of inflation also affects the Company's operating income and expenses in the course of the year.

In addition, the Company's tariff updating mechanism, which was determined in regulations and is reviewed once a year, is influenced by the CPI. As a result, the annual rate of inflation and its distribution over the year can have a material influence on the erosion of the Company's tariffs and on its revenues over the year. The rate of inflation affects the Company's expenses but some of these, mainly the salary expenses, have other direct or indirect linkage mechanisms.

In order to minimize exposure to inflation, the Company's Board decided to implement full or partial hedging, at its discretion, in accordance with the following:

A. Hedging activity will be implemented mainly by means of CPI-shekel forward transactions which guarantee a defined rise in the CPI over a designated period.

B. Transactions will be subject to discretion and in accordance with market trading restrictions and occasions where the price is deemed to be attractive in relation to inflation expectations in the debenture market and inflation forecasts on the one hand, and in relation to the Bank of Israel Inflation Target Center on the other.

C. It will be possible to reduce a hedging position by closing existing transactions before their final expiration date.

D. As long as this exposure is more than NIS 500 million, the hedging rate will not be less than 20% of the exposure and will not exceed 80%; where the exposure is less than NIS 500 million, the hedging rate will not exceed 50% of the exposure.

The Company made hedging transactions against the CPI in order to minimize the risk.

The Company incurred no material costs in making these hedging transactions since they were made as forward transactions.

Interest – The Company's exposure to change in the interest rate largely depends on the nature of its financial liabilities and assets as well as future financing needs. Part of the Company's liabilities bears fixed interest, and therefore a change in the interest rate will affect its fair value rather than its carrying value. Part of the Company liabilities bears variable prime-based interest.

At the date of this report, the Company does not hedge against the exposures described above. It is not inconceivable, however, that it will do so in future market circumstances. Furthermore, the Company takes into account such influences when considering the types of loans it takes.

Exchange rates – A change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future profit and cash flows, mainly payments for the purchase of equipment, raw materials and currency-linked services.

In order to minimize this exposure, the Board of Directors decided that the Company should hedge its exposure against exchange rate risks, subject to the following principles and rules:

A. The unhedged equity exposure to exchange rate risks will not exceed a sum equivalent to USD 200 million.

B. The decision whether to hedge purchase and/or investment transactions will be made, if at all, on the date of the purchase and/or investment decision, or shortly thereafter insofar as possible.

The Company incurred no significant costs in making hedging transactions against exchange rates since they were made as forward transactions.

Prices of raw materials and equipment – The cash flow generated by the Company's operations is used partly for investment in equipment. Equipment prices are affected by the indexes to which they are linked, including sectoral price indexes, global exchange rates and prices. The Company does not hedge against this exposure.

Copper scrap prices – The Company is exposed to changes in copper prices that result in a change in the residual value of its copper cable infrastructure. In addition, the Company is withdrawing and selling copper cables at the same time as it is deploying the NGN network, and in view of the significant cash flows expected from sale of the copper and the volatility of its price, the Board of Directors of the Company approved transactions to hedge its exposure to the value of the copper assets that will be sold as part of the NGN project. In the reporting period the Company implemented hedging transactions against copper prices in the net amount of 3,146 tons. The fair value of the transactions at December 31, 2010 amounted to USD 2.8 million.

Risks and risk management in the consolidated companies

In accordance with a decision of the Board of Directors, each of the companies in the Group is required to manage a risk management policy and routinely monitor performance. The persons responsible for management of the market risks in the principal consolidated companies are the deputy CFOs of those companies. Pelephone’s policy is to partially hedge its accounting and cash flow exposure to market risks based on its assessments and expectations of the parameters affecting the risk.

For more information about financial risk management in the Group, see Note 31 to the financial statements.

Linkage bases report

Note 32 to the financial statements contains information regarding the linkage conditions relating to the Group’s balance sheet balances.

Below is a sensitivity analysis of the Group’s assets and liabilities to changes in foreign currency and CPI rates.

Sensitivity analysis for 2010 (in NIS millions)

Sensitivity to changes in the USD/NIS exchange rate – 2010

The table shows the items sensitive to changes in the dollar/shekel exchange rate. The sensitivity of the items in the balance sheet was examined, as were off-balance-sheet items. The firm commitments are off-balance-sheet commitments, denominated in and/or linked to the dollar and therefore sensitive to changes in the exchange rate. The fair value of the firm commitments was calculated by discounting future cash flow. The Group has minor exposure to changes in the exchange rate of other foreign currencies, with the exception of the US dollar.

	Profit (loss) from changes		Fair value assets (liabilities)	Profit (loss) from changes	
	10%	5%	At a dollar rate of 3.549	-5%	-10%
Cash	2	1	21	(1)	(2)
Trade receivables	4	2	39	(2)	(4)
Long-term trade receivables	-	-	4	-	-
Investments	3	1	29	(1)	(3)
Trade payables, payables and credit balances	(17)	(9)	(173)	9	17
Firm commitments – suppliers	(57)	(28)	(570)	28	57
Firm commitments – rent	(3)	(2)	(35)	2	3
Guarantees	(9)	(5)	(91)	5	9
Hedging instruments not recognized for accounting					
Copper forward transactions in USD	(1)	(1)	(11)	1	1
Total	**(78)**	**(41)**	**(787)**	**41**	**78**

Sensitivity to changes in the CPI – 2010

A sensitivity analysis of 5% and 10% (up and down) was prepared on an inflation assessment of 2% per year, based on the Inflation Target Center at the Bank of Israel. Also analyzed was an extreme scenario of 1.5% per month (up and down), according to a historical review of the past ten years (a monthly change of 1.5% in April 2002) of change in the CPI.

The Group has an investment in loans to an associate which is accounted by the equity method, and a liability in respect of CPI-linked debentures and loans. The Group also has firm CPI-linked commitments (for rent, vehicle leasing agreements and agreements with suppliers)I. The fair value of the firm commitments was calculated by discounting future cash flow.

	Profit (loss) from changes			**Fair value assets (liabilities)**	**Profit (loss) from changes**		
	1.5%	**0.2%**	**0.1%**		**-0.1%**	**-0.2%**	**-1.5%**
Loans to an associate accounted by the equity method	20	3	1	1,312	(1)	(3)	(20)
Trade receivables	1	-	-	86	-	-	(1)
Long-term trade receivables	2	-	-	154	-	-	(2)
Other liabilities and provisions	(7)	(1)	-	(483)	-	1	7
Firm commitments – vehicle leasing	(1)	-	-	(97)	-	-	1
Firm commitments – suppliers	(1)	-	-	(39)	-	-	1
Firm commitments – rent	(8)	(1)	(1)	(515)	1	1	8
Guarantees	(1)	-	-	(55)	-	-	1
Debentures issued to financial institutions and others	(10)	(1)	(1)	(649)	1	1	10
Debentures issued to financial institutions and others	(2)	-	-	(111)	-	-	2
Debentures issued to the public – Series 4	(6)	(1)	-	(368)	-	1	6
Debentures issued to the public – Series 5	(30)	(4)	(2)	(2,019)	2	4	30
Bank loans	(3)	-	-	(192)	-	-	3
Hedging instruments not recognized for accounting							
CPI forward transactions	6	1	-	12	-	(1)	(6)
Total	**(40)**	**(4)**	**(3)**	**(2,964)**	**3**	**4**	**40**

Sensitivity to changes in real shekel interest rates – 2010

The sensitivity analysis of shekel interest includes another scenario (16% up and 16% down) which examines the most extreme daily change of the past ten years. The Group's companies have an investment in loans to an associate accounted by the equity method at fixed interest and linked to the CPI, as well as a liability in respect of CPI-linked debentures at fixed interest. These instruments are sensitive to changes in the real shekel interest rate. The fair value of the loans to an associate was calculated discounting future cash flow at an average interest of 10.56%, which is the effective rate that includes the risk component of the associate.

Debentures issued to the public – Series 4, were traded on December 31, 2010 with a yield of 0.04% and an average duration of 0.42. Debentures issued to the public – Series 5, were traded on December 31, 2010 with a yield of 1.23% and an average duration of 2.75. Changes in the fair value of the debentures was calculated by discounting the cash flow. The fair value of the debentures is stated at the stock market value, i.e. by multiplying the market price on December 31, 2010 by the quantity of the issued nominal value. The fair value of non-negotiable debentures was calculated by discounting the future cash flow at an average interest rate of 1.038% to 1.32%. CPI-linked loans from banking corporations with sensitivity to changes in real shekel interest were discounted at an average rate of 1.39%

	Profit (loss) from changes			**Fair value assets (liabilities)**	**Profit (loss) from changes**		
	16%	**10%**	**5%**		**5%-**	**10%-**	**16%-**
Long-term receivables	(1)	(1)	-	108	-	1	1
Loans to an associate accounted by the equity method	(122)	(78)	(40)	1,312	41	83	136
Debentures issued to financial institutions and others	3	2	1	(649)	(1)	(2)	(3)
Debentures issued to financial institutions and others	-	-	-	(111)	-	-	-
Debentures issued to the public – Series 4	-	-	-	(368)	-	-	-
Debentures issued to the public – Series 5	11	7	3	(2,019)	(3)	(7)	(11)
Bank loans	1	1	-	(192)	-	(1)	(1)
Hedging instruments not recognized for accounting							
CPI forward transactions	-	-	-	12	-	-	-
Total	**(108)**	**(69)**	**(36)**	**(1,907)**	**37**	**74**	**122**

Sensitivity to changes in nominal shekel interest rates – 2010

The sensitivity analysis of the nominal shekel interest rate includes another scenario (16% up and 16% down), which examines the most extreme daily change that occurred in the past ten years. The Group has trade receivables that are paid in installments. The fair value of these balances was calculated by discounting the future cash flow at an average interest rate between 5.04% and 5.65%.

In the course of the year the Group took out fixed-interest shekel loans with sensitivity to changes in the nominal shekel interest rate. The fair value of these loans was calculated by discounting the future cash flow at an average interest rate of 5.42%.

	Profit (loss) from changes			**Fair value assets (liabilities)**	**Profit (loss) from changes**		
	16%	**10%**	**5%**		**5%-**	**10%-**	**16%-**
Trade and other receivables paid in installments	(14)	(9)	(4)	1,813	4	9	14
Investments, deposits and debit balances	-	-	-	100	-	-	-
Bank loans	44	28	14	(1,309)	(14)	(28)	(46)
Hedging instruments not recognized for accounting							
CPI forward transactions	2	1	-	12	-	(1)	(2)
Total	**32**	**20**	**10**	**616**	**(10)**	**(20)**	**(34)**

Sensitivity analysis 2009 (in NIS millions)

Sensitivity to changes in the USD/NIS exchange rate – 2009

The table shows the items sensitive to fluctuations in the dollar/shekel exchange rate. The sensitivity of the items in the balance sheet was examined, as were off-balance sheet items. The firm commitments are off-balance sheet commitments, denominated and/or linked to the dollar and therefore sensitive to changes in the exchange rate. The fair value of the firm commitments was calculated by discounting future cash flow. The Group has minor exposure to changes in the exchange rate of other foreign currencies, with the exception of the US dollar.

	Profit (loss) from changes		**Fair value assets (liabilities)**	**Profit (loss) from changes**	
	10%	**5%**	**At a dollar rate of 3.775**	**-5%**	**-10%**
Cash	2	1	23	(1)	(2)
Receivable	6	3	60	(3)	(6)
Long-term receivables	1	-	5	-	(1)
Investments	3	2	31	(2)	(3)
Trade payables, payables and credit balances	(26)	(13)	(257)	13	26
Firm commitments - suppliers	(93)	(46)	(929)	46	93
Firm commitments - rent	(4)	(2)	(36)	2	4
Guarantees	(10)	(5)	(101)	5	10
Hedging instruments not recognized for accounting					
Dollar/shekel forward transactions	4	2	(1)	(2)	(4)
Dollar/shekel sale option	1	1	(1)	(1)	(3)
Dollar/shekel purchase option	-	-	-	1	2
Total	**(116)**	**(57)**	**(1,206)**	**58**	**116**

Sensitivity to changes in the CPI – 2009

A sensitivity analysis of 5% and 10% (up and down) was conducted on an inflation assessment of 2% per year, based on the Inflation Target Center at the Bank of Israel. The analysis of sensitivity to changes in the CPI includes an extreme scenario of 1.5% per month (up and down) in accordance with a historical examination of changes in the CPI in the past ten years (a monthly change of 1.5% in April 2002).

The Group has an investment in loans to an associate which is accounted by the equity method and a liability for debentures and CPI-linked loans. The Group also has firm CPI-linked commitments (for rent, vehicle leasing and agreements with suppliers). The fair value of the firm commitments was calculated by discounting the future cash flow.

	Profit (loss) from changes			**Fair value assets (liabilities)**	**Profit (loss) from changes**		
	1.5%	**0.2%**	**0.1%**		**-0.1%**	**-0.2%**	**-1.5%**
Loans to an associate accounted by the equity method	18	2	1	1,182	(1)	(2)	(18)
Trade receivables and receivables	-	-	-	35	-	-	-
Long-term receivables	1	-	-	91	-	-	(1)
Other liabilities and provisions	(6)	(1)	-	(412)	-	1	6
Firm commitments – vehicle leasing	(3)	-	-	(158)	-	-	3
Firm commitments – suppliers	-	-	-	(25)	-	-	-
Firm commitments - rent	(7)	(1)	-	(490)	-	1	7
Guarantees	(1)	-	-	(37)	-	-	1
Debentures issued to financial institutes and others	(11)	(1)	(1)	(734)	1	1	11
Debentures issued to financial institutes and others	(5)	(1)	-	(345)	-	1	5
Debentures issued to the public – Series 4	(11)	(1)	(1)	(733)	1	1	11
Debentures issued to the public – Series 5	(30)	(4)	(2)	(1,974)	2	4	30
Loans from banking corporations	(4)	-	-	(235)	-	-	4
Hedging instruments not recognized for accounting							
CPI forward transactions	8	1	-	21	-	(1)	(8)
Total	**(51)**	**(6)**	**(3)**	**(3,814)**	**3**	**6**	**51**

Sensitivity to changes in real shekel interest rates – 2009

The Group's companies have an investment in fixed-interest CPI-linked loans to an associate accounted by the equity method and liabilities for index-linked debentures at fixed interest. These debentures are sensitive to changes in the real shekel interest rate. The fair value of loans to an associate is calculated by discounting future cash flow at an average interest of 10.36% which is the effective interest including the risk component of the associate.

Debentures issued to the public – Series 4 – were traded on December 31, 2009 with a yield of 0.32% and an average life of 0.9. Debentures issued to the public – Series 5 – were traded on December 31, 2009 with a yield of 2.18% and an average life of 3.57. Changes in the fair value of the debentures was calculated by discounting the cash flow. The fair value of the debentures is presented at the stock market value, in other words, by multiplying the market price on December 31, 2009 by the quantity of the issued nominal value. The fair value of non-negotiable debentures was calculated by discounting the future cash flows at an average interest rate of 0.82% to 4.25%. Loans from banks and other institutions are linked to the CPI and sensitive to changes in real shekel interest. These loans were discounted at an average interest rate of 2.44%.

	Profit (loss) from changes		**Fair value assets (liabilities)**	**Profit (loss) from changes**	
	10%	**5%**		**-5%**	**-10%**
Long-term receivables	-	-	50	-	-
Loans to an associate accounted by the equity method	(79)	(40)	1,182	42	86
Debentures issued to financial institutes and others	7	4	(734)	(4)	(7)
Debentures issued to financial institutes and others	-	-	(345)	-	-
Debentures issued to the public -Series 4	-	-	(733)	-	-
Debentures issued to the public - Series 5	15	8	(1,974)	(8)	15
Bank loans	1	1	(235)	(1)	(1)
Hedging instruments not recognized for accounting					
CPI forward transactions	-	-	21	-	-
Total	**(56)**	**(27)**	**(2,768)**	**29**	**63**

Sensitivity to changes in nominal shekel interest rates – 2009

The sensitivity analysis of the shekel interest rate includes another scenario (12% up and down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 12% in December 2001). The Group has receivables balances payable in installments. The fair value of these balances is calculated by discounting the future cash flow at an average interest rate of between 3.957% and 5.26%.

	Profit (loss) from changes			**Fair value assets (liabilities)**	**Profit (loss) from changes**		
	12%	**10%**	**5%**		**5%-**	**10%-**	**12%-**
Accounts receivable repaid in installments	(9)	(7)	(4)	1,504	4	8	9
Investments, deposits and debit balances	-	-	-	83	-	-	-
Hedging instruments not recognized for accounting							
CPI forward transactions	2	1	1	21	(1)	(1)	(2)
Dollar / shekel forward transactions	-	-	-	(1)	-	-	-
Options							
Dollar / shekel sale option	-	-	-	(1)	-	-	-
Total	**(7)**	**(6)**	**(3)**	**1,606**	**3**	**7**	**7**

C. Aspects of Corporate governance

1. Group involvement in the community and donations

The Group companies are active in the community through donations to not-for-profit associations and social organizations which promote education, welfare and other causes. Activities are expressed in money donations, contributions of communications infrastructures, and the encouragement of volunteering by employees carrying out a range of activities for the community.

The guiding principle of the Company's contribution to the community this year was support for programs aimed at narrowing social-educational gaps that exist due to non-availability of computers and the internet ("the digital divide") in the world.

In 2010, the Group donated NIS 12.5 million, and intends to increase its donation budget for 2011.

2. Disclosure of the process for approval of the Company's financial statements

2.1. Committee

The Committee for the Examination of the Company's Financial Statements is a separate committee which does not also serve as the Audit Committee. It is noted that some of the members of the Audit Committee are also members of the Committee for the Examination of the Financial Statements (Mordechai Keret – external director, Yitzhak Edelman – external director).

2.2 Committee members

The committee comprises the following three members: Yitzhak Edelman, committee chairman (external director), Mordechai Keret (external director) and Eldad Ben-Moshe (independent director), each of whom has accounting and financial expertise. All the committee members gave declarations prior to their appointments. For additional details regarding the directors who are committee members, see Chapter D.

2.3 Approval of the financial statements

A The Committee for the Examination of the Financial Statements discussed and formulated its recommendations for the Board in its meetings of February 24 and March 3, 2011.

B All the committee members took part in the above committee discussions.

C Aside from the committee members, present at the committee's meeting of February 24: Chairman of the Board, Mr Shaul Elovitch, Company CEO Mr Avi Gabbay, Deputy CEO and CFO Mr Alan Gelman, Company Controller, Mr Danny Oz, the internal auditor, Mr Lior Segal, the director Mr Rami Nomkin, Legal Counsel Mr Amir Nachlieli, the external auditors and other officers of the Company. Present at the committee meeting of March 3, 2011 were Chairman of the Board, Mr Shaul Elovitch, Company CEO Mr Avi Gabbay, Deputy CEO and CFO Mr Alan Gelman, Company Controller, Mr Danny Oz, the internal auditor, Mr Lior Segal, the director Mr Rami Nomkin, Company Secretary Linor Yochelman, Legal Counsel Mr Amir Nachlieli, the external auditors and other officers of the Company.

D The Committee reviewed the assessments and estimates made in connection with the financial statements, internal controls relating to the financial reporting, the completeness and appropriateness of the disclosure in the financial statements, the accounting policy adopted and the accounting treatment applied in the Corporation's material affairs, the value assessments, including underlying assumptions and estimates on which the data of the financial statements are based. The Committee's discussions were based on the material presented to it in connection with these topics by the Company's management and the questions and answers which arose and were discussed in the course of the discussion, including the comments made by the external auditor in respect of these matters.

E The committee's recommendations were transferred in writing to the Board on March 3, 2011.

F The Committee drew the attention of the Board members to the fact that there are a number of controls to be completed by the Company by the date of the Board meeting and the Board should ascertain their completion in its discussion of the Company's financial statements for 2010.

G The Board discussed the recommendations of the Committee for the Examination of the Financial Statements on March 7, 2011.

H The Board believes that the recommendations of the Committee for the Examination of the Financial Statements were submitted a reasonable time (which was set by the Board at up to 72 hours before the date of the Board meeting) before the Board meeting, also taking into account the scope and complexity of the recommendations.

I The Board accepted the recommendations of the Committee for the Examination of the Financial Statements, reviewed the completion of the controls mentioned in section G and decided to approve the Company's financial statements for 2010.

3. Disclosure concerning the auditor's fees

Below are the fees paid to the auditors of the main companies in the Group for auditing services and audit-related services:

Company	Auditor	Details	2010 (NIS '000)		2009	
			Fee	Hours	Fee	Hours
Bezeq	Somekh Chaikin	Audit and audit-related services	3,964	15,300	2,323	10,125
		Other services	168	432	368	1,122
Pelephone	Somekh Chaikin	Audit and audit-related services	1,665	6,529	1,278	5,475
		Other services	63	162	107	320
Bezeq International	Somekh Chaikin	Audit and audit-related services	860	4,100	517	2,335
		Other services	158	438	76	195

The audit and ancillary audit hours increased in 2010 primarily as a result of an examination of compliance with the provisions of the securities regulations relating to internal audits.

The auditors' fees were discussed by the Committee for the Examination of the Financial Statements and approved by the boards of directors of the Company and of each of the Group companies. The fees were determined on the basis of the hours worked and the hourly tariff in the prior year and with adjustment for changes and events which occurred in the reporting year.

4. Directors with accounting and financial expertise and independent directors

A. The Company's Board of Directors determined that the minimum number of directors with accounting and financial expertise, as required by the provisions of the Companies Law, shall be one (and together with one of the external directors – two). The Board believes that this number will enable it to fulfill its statutory duties and the duties imposed by the documents of association, including review of the financial condition of the Company and preparing and approving the financial statements, taking into consideration the volume and complexity of its operations.

B. Serving directors in the Company who have the above skills are Shlomo Rodav, Shaul Elovitch, Or Elovitch, Felix Cohen, Eldad Ben-Moshe, Yehoshua Rosenzweig, Mordechai Keret (external director) and Yitzhak Edelman (external director). For information about their relevant education and experience, see Section 14 in Chapter D of the Periodic Report.

C. The Company has not adopted in its articles the "Directive concerning the percentage of independent directors" as defined in Article 19(2)(E) of the Companies Law.

5. Disclosure regarding an internal auditor in a reporting corporation

A. The Company's internal auditor

1. Name: Lior Segal. Until December 2, 2010 the auditor was Malka Dror.

2. Date of commencement of office: January 24, 2011. Date of termination of service of the previous auditor: December 2, 2010. Her tenure was terminated by agreement. During the period between the termination of Malka Dror's service and the start of Lior Segal's service, Avi Alkobi, an employee in the Company's internal audit department, was appointed as acting internal auditor).

3. The internal auditor complies with the conditions set forth in Article 3(A) of the Internal Audit Law. Qualifications: Lawyer and accountant, LLB, BA, Accounting and MBA, Tel Aviv University. The internal auditor has a number of years' experience in reporting corporations with material operations, which operate in the communications sector.

4. The internal auditor complies with the provisions of Article 8 of the Internal Audit Law, 1992 and Article 146(B) of the Companies Law, 1999.

5. Method of employment: the internal auditor is a Company employee. The Company has an audit unit which is headed by the internal auditor.

B. Method of appointment

Audit Committee discussion at its meeting on January 14, 2011. The committee recommended appointing Lior Segal as the Company's internal auditor. The appointment was approved by the Board of Directors on January 24, 2011.

Summary of the reasons for approving the appointment

The Board of Directors approved the appointment of Lior Segal, who, prior to his appointment as internal auditor, served as manager of internal processes and controls and compliance officer in corporate governance, to the post of internal auditor, following a recommendation from the Audit Committee, owing to his qualifications and professional experience.

Duties, authority and tasks of the internal auditor

The authority and responsibility of the Company's internal auditor are laid down in the Company's internal audit procedure. The procedure was revised and approved by the Audit Committee on December 19, 2010.

Duties of the internal auditor according to the Company's internal audit procedure

Following are the duties of the internal auditor:

1. To examine the propriety of the operations of the Company and the actions of its officers and office-holders from the following aspects: compliance with the law, regulations and any statute applicable to the Company; good business practice; maintenance of the principles of good management, efficiency, thrift and integrity; to examine whether they were carried out lawfully by a qualified person, whether they were accepted for business reasons and are beneficial to the achievement of the Company's defined goals; to examine their compatibility with the policy and decisions made by Board of Directors and Company management.

2. Examine the reliability and integrity of the financial and operating information.

3. Examine the Company's financial management and liabilities.

4. Examine whether the Company's decisions, including those of its Board of Directors and its committees, were made in accordance with proper procedures.

5. Examine the Company IT systems and its data protection setup.

6. Examine every material transaction of the Company, including the approval processes.

7. Examine the appropriateness and effectiveness of the Company's agreement procedures.

8. Examine the need to amend procedures pertaining to material topics.

9. Examine flaws in the Company's business transaction management.

10. Conduct repeated audits where necessary.

Authority of the internal auditor according to the Company's internal audit procedure

Following are the principal powers of the internal auditor:

1. Receive any information, explanation and document required for the performance of his duties.

2. Gain access to any ordinary information or computer information, any database and any automated or non-automated data processing work plan of the Company and its units.

3. Right of entry to any Company asset.

4. Right to be invited to any management, Board of Directors or committee meeting.

C. The organizational superior of the internal auditor

The internal auditor answers to the CEO.

D. Work plan

1. The work plan is annual.

2. **Considerations in determining the internal audit work plan**

   The guiding principle underlying the annual work plan of the internal audit is the risk inherent in the Company's processes and operations. To assess the risks, the audit prepares a 'control risk survey' of the Company at least once every three years. As part of this survey, the audit examines, in cooperation with the Company's senior management, the material exposures and risks in the Company's operations and the control environment existing for management of these risks. The survey findings are used to compile the topics for the annual and multi-year work plan.

   The last survey was conducted in 2007 and served as a basis for the 2008-2011 work plan. In 2011 the Company intends to conduct a new control risk survey..

   The considerations taken into account in compiling the work plan are these: reasonable coverage of most of the Company's areas of operation based on exposure to material risks, including the controls existing in the Company's areas of operation and the findings of previous audits.

3. **Entities involved in compiling the work plan**

   The internal auditor, management, the CEO, the Audit Committee, the Chairman of the Board.

4. **Entity accepting and approving the work plan**

   The Audit Committee.

5. **The auditor's discretion to deviate from the work plan**

   The auditor may propose subjects at his discretion or at the request of the CEO, and he may also recommend reducing or halting an audit of a topic approved in the work plan. In any event the approval of the Audit Committee chairman is required **to deviate from the work plan**.

6. During the reporting year the auditor did not examine any material transactions made.

E. The audit and the corporations which are material holdings

The work plan of the internal audit unit does not include an audit in corporations which are material holdings. All the corporations that are material holdings of the Company have their own internal auditors (either as employees or outsourced). The audit reports are discussed in the audit committees and/or boards of directors of these corporations, on which directors of the Company serve. The internal auditor may, under the Company's internal audit procedure and at his discretion, obtain the audit reports of the subsidiaries' statements and he is obligated to hold a work meeting with each of the internal auditors of the subsidiaries at least once a year, to discuss the audit plan and its implementation in the subsidiary.

F. Scope of employment

1. Number of hours of employment in the year

The audit's work plan for 2010 included 7,200 audit hours. The internal audit unit at the end of the reporting year employed four full-time internal auditors in addition to the Company's internal auditor.

2. Reduction in volume of internal auditor's work in the reporting year

In accordance with the audit procedure, the internal auditor submitted an annual work plan for 2010 to the Audit Committee, which is derived from the multi-year plan. The Audit Committee approved the work plan for 2010, and this was the source of the decision to reduce the audit budget by 20% in 2010 compared with the 2009 budget. The 2010 budget allows for the employment of 4 auditors in addition to the Company's auditor (a staff reduction of one employee from the internal audit unit as of the beginning of 2010).

G. Preparation of the audit

1. Work standards

Bezeq's internal audit is prepared according to the binding standards of the Institute of Internal Auditors (I.I.A.).

2. The Board's criteria for ensuring that the auditor complies with all the requirements of the standards

In December 2004 an external audit investigation of Bezeq's internal audit unit was carried out in compliance with an I.I.A. standard. The conclusion of this audit was that the work of the Company's internal audit unit complies with accepted professional internal audit standards. An external audit of the internal audit unit is scheduled for 2011.

H. Access to information

The internal auditor was furnished with documents and information as stipulated in Section 9 of the Internal Audit Law, and he was granted permanent direct access to the Company's information systems, including financial data.

I. Internal Auditor's report

The internal auditor submits the audit reports in writing.

The internal auditor routinely submits the audit reports during the reporting year to the Chairman of the Board, the CEO, the Audit Committee chairman and members. The Audit Committee conducts regular discussions of the audit reports.

The Audit Committee held 22 meetings in 2010 and discussed 14 audit reports. Following are the dates of submission of the auditor's reports and the dates of the discussions by the Audit Committee in the reporting year:

No.	Submission date	Committee discussion date
1	December 3, 2009	January 24, 2009
2	January 31, 2010	February 14, 2010
3	March 16, 2010	March 22, 2010
4	December 8, 2009	March 22, 2010
5	January 10, 2010	March 22, 2010
6	February 3, 2010	March 22, 2010
7	February 28, 2010	March 22, 2010
8	March 16, 2010	March 22, 2010
9	March 4, 2010	March 22, 2010

No.	Submission date	Committee discussion date
10	March 15, 2010	March 25, 2010
11	March 16, 2010	March 25, 2010
12	February 25, 2010	March 25, 2010
13	September 16, 2010	October 13, 2010
14	September 16, 2010	October 13, 2010

J. The Board of Directors' assessment of the work of the Internal Auditor

The members of the Company's Board of Directors believe that that the scope of the Company audit performed in 2010, the nature and continuity of the internal auditor's activities as well as the work plan, are reasonable in the circumstances and they can achieve the objectives of the audit.

K. Remuneration

1. The terms of employment of the internal auditor were discussed and approved by the Audit Committee and the Board of Directors as follows: Monthly salary of NIS 36,000 and an annual target-based bonus set in advance by the Audit Committee and approved by the Board of Directors, of up to 25% of his annual salary excluding incidentals.

2. With regard to the Company's previous internal auditor – on December 2, 2010 the internal auditor terminated her service. The terms of her employment were discussed and approved by the Audit Committee and the Company's board of directors, as follows: total monthly salary of NIS 40,000 linked to the CPI from the date of her appointment and an annual target-based bonus set in advance by the Audit Committee and approved by the board of directors of up to 50% of her annual salary excluding incidentals. In accordance with a Board decision of December 2, 2010 she was granted a special retirement bonus of NIS 200,000 (a transition to retirement conditions was due to her under her employment agreement). The special bonus was granted primarily for the period of her service as manager of the Company's audit unit. In this period she encountered variable conditions and displayed responsibility and dedication to the Company and its areas operations. Pursuant to her employment agreement, the outgoing internal auditor is entitled to exercise all the stock options (100,000) which were allotted to her in accordance with a Board resolution of March 10, 2008 as part of an allotment to middle managers in the Company under an outline published on March 11, 2008.

3. The Board of Directors believes that the remuneration of the internal auditor did not affect his professional judgment.

6. Code of ethics

In October 2007, the Board of Directors of the Company re-adopted a code of ethics. The code establishes rules and principles of behavior for guiding the actions of officers, managers and employees in the Company. The code was formulated in the Company in 2005, and the new version incorporates a number of changes and revisions. The Board of Directors authorized the Company's management to ensure the assimilation of the code of ethics in the Company, and decided that it would become part of the binding procedures of the Company. At the end of 2008 the code of ethics was assimilated at the Company's management level. Since 2009 its assimilation among Company employees is being accomplished as part of the management routine.

7. The authority of the CEO

On September 4, 2007, the Board resolved, in accordance with Section 50(A) of the Companies Law, 5759-1999 and with Articles 119 and 121.1 of the Company's Articles of Association, that the authority of the CEO in all matters pertains to the corporations held, directly or indirectly, by the Company, (including Pelephone, Bezeq International, DBS, Walla, Bezeq Online and Bezeq Zahav Holdings) would be transferred to the Board of Directors which passed resolutions for implementation of this decision.

D. Disclosure concerning the financial reporting of the corporation

1. Critical accounting estimates

Preparation of the financial statements in accordance with IFRS requires management to make assessments and estimates that affect the reported values of the assets, liabilities, income and expenses, as well as the disclosure in connection with contingent assets and liabilities. Management bases these assessments and estimates on past experience and on valuations, expert opinions and other factors which it believes are relevant in the circumstances. Actual results might differ from these assessments with different assumptions or conditions. Information about primary topics of uncertainty in critical estimates and judgments made in the application of the accounting policy is provided in the financial statements (see Note 2G). We believe that these assessments and estimates are critical since any change in these assessments and assumptions could potentially have a material effect on the financial statements.

Estimated useful life of property, plant and equipment

The estimated useful lives of property, plant and equipment serve to determine the depreciation expenses that will be recorded in the reporting year. The main part of the communications infrastructure is managed according to asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past experience, taking into consideration expected technological changes, company plans or other changes. If such changes occur earlier than foreseen or differently from expectations, the remaining useful life of such assets might be shortened. This results in an increase in future depreciation expenses. If the changes occur later than expected, the remaining useful life may be extended, and this results in a decrease in the depreciation expenses. Given the significant amounts of the Group's depreciation expenses, such changes can have a material effect on the results of the actions and the financial position of the Group.

Assessing the value of items of property, plant and equipment

Certain items of property, plant and equipment were re-valued to fair value upon the transition to IFRS, based on their deemed cost, which was determined on the basis of their value on the transition date (January 1, 2005) according to the Group's estimate based on the valuation of an external appraiser. In addition, the costs of dismantling, clearing and restoring sites were capitalized to the date of transition to IFRS.

The residual value of the Company's copper cables was determined on the basis of the Company's assessment. The Company is exposed to changes in the prices of copper, which cause a change in the residual value of the copper infrastructure (see Note 10B to the financial statements).

The use of estimates and assessments affects the items of property, plant and equipment and the depreciation expense (see Note 10 to the financial statements).

Employee benefit liability

These liabilities are based on actuarial calculations that include numerous calculation assumptions which can be different in practice. The assumptions relate, *inter alia*, to interest rates for capitalization, mortality tables, wage creep and turnover rates.

(For additional information, see Note 17 to the financial statements.)

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since according to the Company's business plans realization of the tax benefit is foreseeable. By the nature of things, actual business results may differ from the business plans, and this can affect the future realization of the tax benefit (see Note 9 to the financial statements).

Provisions and contingent liabilities

The Group's companies have contingent liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions in extremely significant amounts are pending against Group companies.

Every year the Company makes estimates of the potential liabilities associated with every claim and action. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is likely to bear the costs of settling claims and whether they can be reliably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with the Company being ordered to pay amounts materially different from the provisions included in the financial statements, if any. (For details of provisions and contingent liabilities, see Notes 16 and 18 to the financial statements.)

Measurement of recoverable amounts of cash-generating units

Recoverable amounts of cash-generating units are measured in order to assess the possibility of impairment of the unit's assets (including goodwill). The measurement involves estimates of the cash flows expected from the units (see Note 11 to the financial statements).

Share-based payments

Share-based payments are measured by means of an economic model that includes estimates in various parameters (see Note 27E to the financial statements).

Provision for doubtful debts

An examination of the need for impairment of financial assets in material amounts is conducted on the basis of each asset separately. For the remaining financial assets the need is examined collectively in accordance with groups of similar credit risk characteristics. In addition, the financial statements contain specific provisions and group provisions for doubtful debts which, in management's opinion, reflect the loss inherent therein

(See Note 8 to the financial statements).

Fair value investment in associates

On the date of termination of the consolidation of DBS Satellite Services Ltd., the Company recorded a fair value investment and allocated the fair value to tangible and intangible assets. This was done by an external appraiser and was also based on various assessments and estimates (see Note 13 to the financial statements).

2. Disclosure of a very material appraisal

Identification of the matter for appraisal	Pelephone's value for the purpose of reviewing impairment of the goodwill which was attributed to it in the Company's financial statements pursuant to IFRS 36. An appraisal is attached as an appendix to the Company's financial statements for 2010.
Timing of the appraisal	Value of goodwill at December 31, 2010; the appraisal was signed on March 6, 2011.
Value of item shortly before appraisal date	NIS 5,134 million carrying amount, net (NIS 1,027 million – balance of goodwill).
Value of item determined on the basis of appraisal	NIS 12,556 million. Pursuant to the value determined in the appraisal, the Company concluded that there is no impairment requiring amortization of the sum of goodwill recorded in the Company's books.

Identification and characterization of the appraiser	Giza Singer Even Ltd. The work was performed by a team headed by Yuval Zilberstein, a partner who has more than 15 years' experience in economic consulting and accounting. He has a BA in Accounting and Economics from the Hebrew University and an MBA from the Hebrew University. The appraiser is not dependent on the Company The Company undertook to indemnify the appraiser in the event of a third-party claim, for reasonable expenses and any amounts he would be ordered to pay in a legal proceeding, unless he acted maliciously or negligently. See Section 10.5 to the appraisal.
Appraisal model	DCF (Discounted Cash Flow)
Assumptions used in the appraisal	• Discounting rate – 11%. Companies used for comparison to determine the discounting rate – Cellcom and Partner • Permanent growth rate – 1% • Scrap value percentage of total value determined in the appraisal – approximately 65% (years in the model – up to 2016)

3. In their opinion on the financial statements the auditors have drawn attention to the materiality of the claims filed against the Group..

4. Events after the balance sheet date

A. On January 24, 2011 the Company's Board approved an early retirement plan for employees whereby up to 260 employees would retire, in a total amount of up to NIS 281.5 million. The expense for this decision will be recorded in the Company's financial statements for the first quarter of 2011 (see Note 17D to the financial statements).

B. In February 2011 the Company accepted from an Israeli banking corporation a letter of undertaking to place at its disposal a long-term credit facility in the amount of NIS 1.5 billion to finance the Company's cash flow needs. (See Note 34 to the financial statements)

C. On March 7, 2011, the Company's Board of Directors of the Company resolved to recommend to the general meeting of the shareholders of the Company, the distribution of a cash dividend to the shareholders in the total amount of NIS 1,163 million.

D. On March 7, 2011 the Company's Board approved the adoption of guidelines and rules for the classification of a transaction of the Company or an associate or an affiliate with an interested party as a negligible transaction as stipulated in Regulation 41(A)(6) of the Securities Regulations (Financial and Annual Statements), 2010. (See Note 30E to the financial statements).

E. In respect of an increase in the remuneration rate, see Section 1.7.31B of the Periodic Report.

F. In respect of recommendations under consideration by the Haik Commission on various structural matters in the communication market, see Section 1.7.3A in Chapter A of the Periodic Report.

E. Details of series of liability certificates

1. Data regarding the Company's debentures in circulation, at December 31, 2010:

		Series 4 debentures	Series 5 debentures
A	Issue date	June 1, 2004	June 1, 2004
B	Total par value on issue date	NIS 1,200,000,000	NIS 2,386,967,000
C	Its par value	NIS 300,000,000	NIS 2,386,967,000(1)
D	Par value reassessed for report date (linked to the CPI)	NIS 350,751,779	NIS 2,790,776,408(2)
E	Accumulated interest	NIS 9,821,050	NIS 86,281,504
F	Fair value	NIS 367,530,000	NIS 3,198,535,780
G	Stock exchange value	NIS 367,530,000	NIS 3,198,535,780
H	Interest type	Set at 4.8%	Set at 5.3%
I	Principal payment dates	June 1 every year through June 1, 2011	June 1 every year from 2011 through 2016
J	Interest payment dates	June 1 every year through 2011	June 1 every year through 2016
K	Linkage	The principal and interest are linked to the CPI (base index April 2004)	The principal and interest are linked to the CPI (base index April 2004)
L	Total liability in relation to Company's liability	Not material	Material

(1) Of which NIS 880.1 million par value held by a wholly-owned subsidiary.

2) Of which NIS 1,029 million held by a wholly-owned subsidiary.

Trust company – Mizrachi Tefahot Trust Company

The contact person in the trust company is Meni Lego, VP Operations. His email address is: meni.lego@umtb.co.il The trustee's address is 123 Hahashmonaim Street, Tel Aviv.

2. For details of the ratings of the series of liability certificates, see Section 2.13.6 in Chapter A of the Periodic Report. On January 2, 2011 the Company was notified by Midroog Ltd. ("Midroog"), which rates the Company's debentures (Series 4 and 5) that Midroog was putting the Aa1 rating it had given the Company's debentures on its watch list with a negative outlook.

On February 6, 2011 S&P Maalot (which rates the Company and its debentures (Series 4 and 5)) ratified its current ilAA+ rating and removed the rating from its credit watch. Negative rating outlook.

The rating reports are attached in an appendix.

3. During and at the end of the reporting year the Company met all the conditions and commitments under the deed of trust and there were no conditions establishing cause to present the certificates of liability for immediate repayment. No collateral was given to secure payment for the holders of the certificates of liability. There is no encumbrance whatsoever on the certificates of liability.

F. Miscellaneous

1. For the forecast of the Bezeq Group, see Section 1.6 in Chapter A of the Periodic Report.

2. On December 30, 2010 the Board decided to recommend to the Company's shareholder general meeting approval of a distribution to shareholders (the "Planned Distribution") amounting to NIS 3 billion, a sum which exceeds the Company's profits. The general meeting approved the Planned Distribution on January 24, 2011. The Planned Distribution is subject to court approval. For further details, see Note 21 to the financial statements.

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

Shaul Elovitch Chairman of the Board of Directors	Abraham Gabbay CEO

BEZEQ THE ISRAEL TELECOMMUNICATION CORP. LIMITED

CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED
DECEMBER 31, 2010

Consolidated Financial Statements for the Year Ended December 31, 2010

Contents

Somekh Chaikin
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Auditors' Report to the Shareholders of "Bezeq" The Israel Telecommunication Corp. Limited
Regarding the Audit of Internal Control Components over Financial Reporting in accordance with paragraph 9b(c) of the Israeli Securities Regulations (Periodic and Immediate Reports), 1970

We have audited internal control components over financial reporting of "Bezeq" The Israel Telecommunication Corp. Limited and its subsidiaries (hereinafter "the Company") as of December 31, 2010. These control components were determined as explained in the following paragraph. The Company's Board of Directors and Management are responsible for maintaining effective internal control over financial reporting and for their assessment of the effectiveness of the Company's internal control components over financial reporting accompanying the periodic report as of the above date. Our responsibility is to express an opinion on the Company's internal control components over financial reporting based on our audit.

Internal control components over financial reporting audited by us were determined in accordance with Auditing Standard 104 of the Institute of Certified Public Accountants in Israel "Audit of Internal Control Components over Financial Reporting" (hereinafter "Auditing Standard 104").

These components are:
(1) Entity level controls, including controls over the preparation and closure of the financial reporting process and information technology general controls;
(2) Controls over revenues process;
(3) Controls over the payroll process;
(4) Controls over fixed assets;
(all these are named together "audited control components").

We conducted our audit in accordance with Auditing Standard 104. This standard requires us to plan and perform the audit to identify the audited control components and to obtain reasonable assurance about whether these control components were effective in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, identifying the audited control components, assessing the risk that a material weakness exists in the audited control components, and testing and evaluating the design and operating effectiveness of those control components based on the assessed risk. Our audit, regarding those control components, also included performing such other procedures as we considered necessary in the circumstances. Our audit referred only to the audited control components, as opposed to internal control over all significant processes related to financial reporting, therefore our opinion refers to the audited control components only. Our audit also did not refer to mutual effects between audited control components and non audited control components, therefore our opinion does not take into account these possible effects. We believe that our audit provides a reasonable basis for our opinion in the context described above.

Because of its inherent limitations, internal control over financial reporting as a whole, and internal control components in particular, may not prevent or detect misstatements. Also, projections of any current evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective audited control components as of December 31, 2010.

We have also audited, in accordance with generally accepted auditing standards in Israel, the Company's consolidated financial statements as of December 31, 2010, 2009 and 2008 and the consolidated income statements, statements of comprehensive income, statements of changes in equity and statements of cash flows, for each of the three years, the last of which ended on December 31, 2010 and our report dated March 7, 2011, expressed an unqualified opinion on those financial statements with an explanatory paragraph regarding claims made against the Company, for which the exposure cannot yet be assessed or calculated.

Somekh Chaikin
Certified Public Accountants

March 7, 2011

Somekh Chaikin
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Auditors' Report to the Shareholders of
"Bezeq" The Israel Telecommunication Corp. Limited

We have audited the accompanying consolidated statements of financial position of "Bezeq" The Israel Telecommunication Corp. Limited (the Company) as of December 31, 2010, 2009 and 2008 and the consolidated income statements, statements of comprehensive income, statements of changes in equity and statements of cash flows, for each of the three years, the last of which ended on December 31, 2010. These financial statements are the responsibility of the Company's Board of Directors and of its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of certain consolidated subsidiaries whose assets constitute 2.6% of the total consolidated assets as of December 31, 2010, and whose revenues constitute 1.1% of the total consolidated revenues for the year ended December 31, 2010. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us, and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in Israel, including standards prescribed by the Auditors' Regulations (Manner of Auditor's Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management of the Company, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the abovementioned other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its consolidated subsidiaries as at December 31, 2010, 2009 and 2008 and their results of operations, changes in its equity and cash flows, for each of the three years, the last of which ended on December 31, 2010, in accordance with International Financial Reporting Standards (IFRS) and in accordance with the Securities Regulations (Annual Financial Statements) - 2010.

We have also audited, in accordance with Auditing Standard 104 of the Institute of Certified Public Accountants in Israel "Audit of Internal Control Components over Financial Reporting", the components of the Company's internal control over financial reporting as of December 31, 2010, and our report dated March 7, 2011 expressed an unqualified opinion on the effectiveness of such components.

Without qualifying our opinion, we draw attention to the claims made against the Company for which the exposure cannot yet be assessed or calculated, as described in Note 18.

Somekh Chaikin
Certified Public Accountants

March 7, 2011

Consolidated Statements of Financial Position as at December 31

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Assets				
Cash and cash equivalents	6	**365**	580	786
Investments, including derivatives	7	**7**	154	33
Trade receivables	8	**2,701**	2,491	2,373
Other receivables	8	**224**	171	211
Inventory		**178**	263	158
Current tax assets		**3**	-	-
Assets classified as held for sale		**29**	40	34
Total current assets		**3,507**	3,699	3,595
Investments, including derivatives	7	**129**	130	187
Trade and other receivables	8	**1,114**	887	576
Broadcasting rights, net of rights exercised		**-**	-	253
Property, plant and equipment	10	**5,610**	5,428*	6,208*
Intangible assets	11	**2,248**	1,885	2,674
Deferred and other expenses	12	**292**	301*	239*
Investments in equity-accounted investees (mainly loans)	13	**1,084**	1,219	32
Deferred tax assets	9	**254**	392	550
Total non-current assets		**10,731**	10,242	10,719
Total assets		**14,238**	13,941	14,314

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Liabilities				
Debentures, loans and borrowings	14	**949**	862	1,780
Trade payables	15	**1,061**	1,091	1,381
Other payables, including derivatives	15	**770**	697	850
Current tax liabilities		**267**	118	45
Deferred income		**33**	36	62
Provisions	16	**251**	380	355
Employee benefits	17	**269**	505	412
Total current liabilities		**3,600**	3,689	4,885
Debentures	14	**1,967**	2,716	3,943
Bank loans	14	**2,801**	558	214
Loans from institutions		**-**	-	158
Loans provided by non-controlling interests in a subsidiary		**-**	-	449
Employee benefits	17	**305**	294	265
Other liabilities		**43**	5	27
Provisions	16	**69**	71	64
Deferred tax liabilities	9	**83**	70	65
Total non-current liabilities		**5,268**	3,714	5,185
Total liabilities		**8,868**	7,403	10,070
Equity				
Total equity attributable to equity holders of the Company		**5,327**	6,544	4,715
Non-controlling interests		**43**	(6)	(471)
Total equity	21	**5,370**	6,538	4,244
Total liabilities and equity		**14,238**	13,941	14,314

Shaul Elovitch
Chairman of the Board of Directors

Avi Gabbay
CEO

Alan Gelman
Deputy CEO and CFO

* Retrospective application by restatement, see Note 2H

Date of approval of the financial statements: March 7, 2011

The attached notes are an integral part of these consolidated financial statements.

Consolidated Statements of Income for the Year Ended December 31

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Continuing operations				
Revenue	22	**11,987**	11,519	11,015
Costs and expenses				
Depreciation and amortization	10,11,12	**1,409**	1,485	1,458
Salaries	23	**2,024**	1,990	2,161
General and operating expenses	24	**5,026**	4,871	4,660
Other operating expenses (income), net	25	**(216)**	201	96
		8,243	8,547	8,375
Operating profit	29	**3,744**	2,972	2,640
Financing income (expenses)	26			
Financing expenses		**391**	398	494
Financing income		**(282)**	(429)	(354)
Financing expenses (income), net		**109**	(31)	140
Profit after financing expenses (income), net		**3,635**	3,003	2,500
Share of profits (losses) of equity accounted investees	13	**(261)**	(34)	5
Profit before income tax		**3,374**	2,969	2,505
Income tax	9	**932**	807	719
Profit for the year from continuing operations		**2,442**	2,162	1,786
Discontinued operations				
Profit (loss) for the year from discontinued operations	13A(2)	**-**	1,379	(265)
Profit for the year		**2,442**	3,541	1,521
Attributable to:				
owners of the Company				
Profit for the year from continuing operations		**2,443**	2,157	1,781
Profit (loss) for the year from discontinued operations		**-**	1,446	(154)
		2,443	3,603	1,627
Non-controlling interests				
Profit (loss) from continuing operations		**(1)**	5	5
Loss from discontinued operations		**-**	(67)	(111)
		(1)	(62)	(106)
Profit for the year		**2,442**	3,541	1,521

Consolidated Statements of Income for the Year Ended December 31 (contd.)

	Note	2010 NIS	2009 NIS	2008 NIS
Earnings per share	28			
Basic earnings per share				
Earnings from continuing operations		**0.91**	0.82	0.68
Earnings (loss) from discontinued operations		**-**	0.55	(0.06)
		0.91	1.37	0.62
Diluted earnings per share				
Profit from continuing operations		**0.90**	0.80	0.68
Profit (loss) from discontinued operations		**-**	0.54	(0.07)
		0.90	1.34	0.61

The attached notes are an integral part of these consolidated financial statements

Consolidated Statements of Comprehensive Income for the Year Ended December 31

	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Profit for the year	**2,442**	3,541	1,521
Other comprehensive income (loss) for the year, net of tax	**13**	(11)	(10)
Total comprehensive income for the year	**2,455**	3,530	1,511
Attributable to:			
Owners of the Company			
Comprehensive income for the year from continuing operations	**2,456**	2,146	1,771
Comprehensive income (loss) for the year from discontinued operations	**-**	1,446	(154)
	2,456	3,592	1,617
Non-controlling interests			
Comprehensive income (loss) for the year from continuing operations	**(1)**	5	5
Comprehensive loss for the year from discontinued operations	**-**	(67)	(111)
	(1)	(62)	(106)
Total comprehensive income for the year	**2,455**	3,530	1,511

The attached notes are an integral part of these consolidated financial statements.

Consolidated Statements of Changes in Equity for the Year Ended December 31

	Share capital	Share premium	Capital reserve for options for employees	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves *	Deficit	Total	Non-controlling interests	Total equity
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
	Attributable to owners of the Company								
Balance as at January 1, 2010	6,187	275	210	390	(5)	(513)	6,544	(6)	6,538
Profit for the year	-	-	-	-	-	2,443	2,443	(1)	2,442
Other comprehensive income for the year, net of tax	-	-	-	-	-	13	13	-	13
Total comprehensive income for the year	-	-	-	-	-	2,456	2,456	(1)	2,455
Transactions with owners recognized directly in equity									
Dividends to Company shareholders	-	-	-	-	-	(3,733)	(3,733)	-	(3,733)
Share-based payments	-	-	39	-	-	-	39	-	39
Exercise of options for Company shares	26	103	(103)	-	-	-	26	-	26
Transfers by non-controlling interests, net	-	-	-	-	-	-	-	2	2
Non-controlling interests in a business combination	-	-	-	-	-	-	-	57	57
Increase in the rate of holding in a subsidiary	-	-	-	-	(5)	-	(5)	(9)	(14)
Balance as at December 31, 2010	6,213	378	146	390	(10)	(1,790)	5,327	43	5,370

* Including translation reserve, reserve from available-for-sale assets and reserve from transactions with non-controlling interests

For details of the application to the court, subsequent to the reporting date, for permission to distribute a cash dividend in the total amount of NIS 3 billion, a sum not in compliance with the profittest, see Note 21.

The attached notes are an integral part of these consolidated financial statements.

Consolidated Statements of Changes in Equity for the Year Ended December 31 (contd.)

	Share capital	Share premium	Capital reserve for options for employees	Capital reserve for a transaction between a corporation and a controlling shareholder	Translation reserve	Deficit	Total	Non-controlling interests	Total equity
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
	Attributable to owners of the Company								
Balance at January 1, 2009	6,132	-	362	390	(4)	(2,165)	4,715	(471)	4,244
Profit for the year	-	-	-	-	-	3,603	3,603	(62)	3,541
Other comprehensive income for the year, net of tax	-	-	-	-	(1)	(10)	(11)	-	(11)
Total comprehensive income for the year	-	-	-	-	(1)	3,593	3,592	(62)	3,530
Transactions with owners recognized directly in equity									
Dividends to Company shareholders	-	-	-	-	-	(1,941)	(1,941)	-	(1,941)
Share-based payments	-	-	49	-	-	-	49	-	49
Exercise of options for Company shares	55	275	(201)	-	-	-	129	-	129
Derecognition of non-controlling interests for deconsolidation of a subsidiary	-	-	-	-	-	-	-	551	551
Dividends to non-controlling interests less transfers	-	-	-	-	-	-	-	(24)	(24)
Balance as at December 31, 2009	6,187	275	210	390	(5)	(513)	6,544	(6)	6,538

The attached notes are an integral part of these consolidated financial statements.

Consolidated Statements of Changes in Equity for the Year Ended December 31 (contd.)

	Share capital	Capital reserve for options for employees	Capital reserve for a transaction between a corporation and a controlling shareholder	Other reserves *	Deficit	Total	Non-controlling interests	Total equity
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
	Attributable to owners of the Company							
Balance as at January 1, 2008	6,132	287	390	4	(2,276)	4,537	(373)	4,164
Profit for the year	-	-	-	-	1,627	1,627	(106)	1,521
Other comprehensive income for the year, net of tax	-	-	-	(8)	(2)	(10)	-	(10)
Comprehensive income for the year	-	-	-	(8)	1,625	1,617	(106)	1,511
Transactions with owners recognized directly in equity								
Dividends to Company shareholders	-	-	-	-	(1,514)	(1,514)	-	(1,514)
Share-based payments	-	75	-	-	-	75	-	75
Transfers by non-controlling interests	-	-	-	-	-	-	8	8
Balance at December 31, 2008	6,132	362	390	(4)	(2,165)	4,715	(471)	4,244

* Including translation reserve and reserve from available-for-sale assets

The attached notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows for the Year Ended December 31

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Cash flows from operating activities				
Profit for the year		**2,442**	3,541	1,521
Adjustments:				
Depreciation	10	**1,114**	1,343*	1,401*
Amortization of intangible assets	11	**269**	266	282*
Amortization of deferred and other expenses	12	**26**	22*	20
Profit from deconsolidation of a subsidiary	13	**-**	(1,538)	-
Profit from a controlling shareholder in an investee	5	**(57)**	-	-
Share of losses (profits) of equity accounted investees	13	**261**	34	(5)
Financing expenses, net	26	**113**	362	561
Capital gain, net	25	**(171)**	(64)	(68)
Expenses (income) for derivatives, net		**12**	-	-
Share-based payments	27	**35**	49	75
Income tax expenses	9	**932**	807	719
Proceeds (payment) of derivatives, net		**(2)**	11	(38)
Change in inventory		**84**	(114)	42
Change in trade and other receivables	8	**(300)**	(546)	(54)
Change in trade and other payables	15	**(21)**	247	(219)
Change in provisions	16	**(136)**	36	(34)
Change in broadcasting rights		**-**	(49)	(11)
Change in employee benefits	17	**(215)**	115	(302)
Change in deferred and other income		**-**	(41)	50
Net income tax paid		**(690)**	(565)	(535)
Net cash from operating activities		**3,696**	3,916	3,405
Cash flow used in investing activities				
Investment in intangible assets and deferred expenses	11,12	**(343)**	(349)	(469)
Proceeds from the sale of property, plant and equipment and other assets		**131**	90	147
Change in current investments, net		**138**	(134)	321
Purchase of property, plant and equipment	10	**(1,279)**	(1,363)	(1,300)
Proceeds from disposal of investments and long-term loans		**11**	93	19
Acquisition of investments and long-term loans		**(6)**	(4)	(8)
Business combinations less cash acquired		**(145)**	-	-
Dividends received		**-**	6	13
Interest received		**9**	29	64
Net cash used in investing activities		**(1,484)**	(1,632)	(1,213)

* Retrospective application by restatement, see Note 2H

The attached notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows for the Year Ended December 31 (contd.)

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Cash flows used in financing activities				
Bank loans received	14	**2,670**	400	-
Repayment of debentures	14	**(697)**	(682)	(714)
Repayment of loans	14	**(448)**	(109)	(148)
Net short-term borrowing	14	**(6)**	48	(50)
Dividends paid	21	**(3,733)**	(1,941)	(1,514)
Interest paid		**(237)**	(354)	(243)
Net proceeds for derivatives		**10**	43	52
Dividends paid to non-controlling interests less transfers, net		**2**	(24)	8
Increase in the rate of holding in a subsidiary		**(14)**	-	-
Proceeds from exercise of options		**26**	129	-
Net cash used for financing activities		**(2,427)**	(2,490)	(2,609)
Net decrease in cash and cash equivalents		**(215)**	(206)	(417)
Cash and cash equivalents at January 1		**580**	786	1,203
Cash and cash equivalents at end of year	6	**365**	580	786

The attached notes are an integral part of these consolidated financial statements.

NOTE 1 – REPORTING ENTITY

A. Bezeq – The Israel Telecommunication Corp. Limited(hereinafter "the Company") is a company registered in Israel whose shares are traded on the Tel Aviv Stock Exchange. The consolidated financial statements of the Company as at December 31, 2010 include those of the Company and its subsidiaries (together referred to as "the Group"), as well as the Group's interest in associates. The Group is a principal provider of communication services in Israel (see also Note 29 – Segment Reporting).

B. BeginingApril 14, 2010, B Communications Ltd. ("B Communications") (formerly 012 Smile Communications Ltd.) is the controlling shareholder of the Company, through B Communications (SP2) Ltd. ("B Communications SP2"), which is wholly owned and controlled (indirectly) by B Communications. At December 31, 2010, B Communications held 30.31% of the Company's shares. The controlling shareholder of B Communications is Internet Gold-Golden Lines Ltd. The controlling shareholder of Internet Gold-Golden Lines Ltd. is Eurocom Communications Ltd. ("Eurocom Communications"). Eurocom Communications is owned by Eurocom Holdings (1979) Ltd., which is controlled by Shaul Elovitch.

C. The Company is subject to various sets of laws that regulate and restrict its business activities, including its tariffs. The Company's tariffs are regulated by provisions in the Communications Law. The Company's service fees are regulated and updatedaccording to a linkage formula. The Company was declared a monopoly in the main areas in which it operates. All the operating segments of the Group are subject to competition. The operations of the Group are subject, in general, to government regulation and supervision. The intensifying competition and changes in the communication market could have an adverse effect on the business results of the Group.

NOTE 2 - BASIS OF PREPARATION

A. Definitions

In these financial statements –

(1) <u>International Financial Reporting Standards (IFRS)</u> – Standards and interpretations that were adopted by the International Accounting Standards Board (IASB) and which include international financial reporting standards and international accounting standards (IAS), along with the interpretations to these standards of the International Financial Reporting Interpretations Committee (IFRIC) or interpretations of the Standing Interpretations Committee (SIC), respectively.

(2) <u>The Company</u>: "Bezeq" The Israel Telecommunication Corporation Limited

(3) <u>The Group</u>: "Bezeq" The Israel Telecommunication Corporation Limited and its subsidiaries, as listed in Note 13 – Investees

(4) <u>Subsidiaries</u>: Companies,including a partnership whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company

(5) <u>Jointly-controlled companies</u>: Companies owned by various entities that have a contractual agreement for common control, and whose financial statements are consolidated with those of the Company using the proportionate consolidation method.

(6) <u>Associates</u>: Companies, including a partnership, in which the Group's investment is included, directly or indirectly, in the consolidated financial statements on the equity basis

(7) <u>Investees</u>: Subsidiaries, Jointly-controlled companies or associates

(8) <u>Related party</u> – As defined in IAS 24, *Related Party Disclosures*

NOTE 2 - BASIS OF PREPARATION (CONTD.)

A. Definitions (contd.)

(9) Interested parties: As defined in paragraph (1) of the definition of an "interested party" in section 1 of the Securities Law, 5728-1968

(10) CPI – The consumer price index as published by the Central Bureau of Statistics

B. Statement of compliance

The Group has prepared the consolidated financial statements in accordance with International Financial Reporting Standards ("IFRS") and in accordance with the Securities Regulations (Annual Financial Statements), 5770-2010.

The consolidated financial statements were approved for publication by the Board of Directors on March 7, 2011.

C. Functional currency and presentation currency

The consolidated financial statements are presented in NIS, which is the Group's functional currency, and have been rounded to the nearest million. The NIS is the currency that represents the principal economic environment in which the Group operates.

D. Basis of measurement

The consolidated financial statements have been prepared on the historical cost basis except for the following items:

- Financial instruments, including financial derivatives, at fair value through profit or loss
- Financial assets classified as available-for-sale at fair value
- investments accounted-Equity
- liabilities and assets tax Deferred
- Provisions
- benefits employee for Liabilities
- Liabilities for cash-settled share-based payment arrangements

The methods used to measure fair value are explained in Note 4. For further information regarding the measurement of these assets and liabilities see Note 3 regarding significant accounting policies.

Values of non-monetary assets and equity items measured on the historical cost basis were adjusted to changes in the CPI until December 31, 2003, since until that date the Israeli economy was considered hyperinflationary.

E. Operating cycle

The Group's operating cycle is up to one year. As a result, the current assets and current liabilities include items of which their realization is intended and anticipated to take place within one year from the date of the financial statements.

F. Classification of expenses recognized in the statement of income

The classification of costs and expenses recognized in the statement of income is based on the function of the expenses. Classification is compatible with the understanding of the Group's businesses, which address a wide range of services using common infrastructure. All of the costs and expenses are used to provide services.

NOTE 2 - BASIS OF PREPARATION (CONTD.)

G. Use of estimates and judgment

The preparation of financial statements in conformity with IFRS requires management to make judgments and use estimates and assumptions that affect application of accounting policies and the reported amounts of assets, liabilities, income and expenses. It is clarified that actual results may differ from these estimates.

The preparation of accounting estimates used in the preparation of the Group's financial statements requires management to make assumptions regarding circumstances and events that involve considerable uncertainty. Management of the Company prepares the estimates on the basis of past experience. In exercising its judgment when making the estimates, management relies on past experience, various facts, external circumstances, and reasonable assumptions according to the pertinent circumstances of each estimate.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Information about critical estimates made by the management while implementing accounting policies and which have the most significant effect on the financial statements is included in the following notes:

- Note 8 - debts doubtful for Provision
- Note 9 - Use of losses for tax purposes and deferred tax assets and liabilities recognized
- Note 10 - Estimated useful life and residual value of items of property, plant and equipment and calculation of deemed cost
- Note 11 - Measurement of recoverable amounts of cash-generating units
- Note 13 - Investment in investees at fair value
- Notes 16 and 18 - Provisions and contingent liabilities
- Note 17 - Measurement of employee benefit liabilities
- Note 27 - Measurement of share-based payments

H. Changes in accounting policies – Initial implementation of new accounting standards

Leases

As from January 1, 2010, the Group implements the amendment to IAS 17 – Leases: Classification of Leases of Land and Buildings ("the Amendment"). The Amendment eliminates the requirement to classify a lease of land as an operating lease when the title is not expected to pass to the lessee at the end of the lease term.

The Company has land lease agreements with the Israel Land Administration, which were accounted for as operating leases prior to implementation of the Amendment. Subsequent to adoption of the Amendment, the Company classified the lease of the land retrospectively as a finance lease. Accordingly, the land is stated as property, plant and equipment in the statement of financial position as at December 31, 2008 and December 31, 2009, in the amount of NIS 172 million and NIS 125 million, respectively. Implementation of the Amendment did not have a further effect.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES

The accounting policies set out below have been applied consistently by Group entities to all periods presented in these consolidated financial statements, except as explained in Note 2(H) – Initial implementation of accounting standards.

A. Basis of consolidation

(1) Business combinations

The Group has opted for early application of IFRS 3 – *Business Combinations* (revised) and IAS 27 – *Consolidated and Separate Financial Statements (2008) as* from January 1, 2008.
Business combinations are accounted for by applying the acquisition method. According to this method, the identifiable assets and liabilities of the acquired business are recognized and recorded at fair value on the acquisition date.

The acquisition date is the date on which the acquirer obtains control over the acquiree. Control exists when the Company is able to govern the financial and operating policies of the entity so as to obtain benefits from its activities. In assessing control, potential voting rights were taken into account if they confer effective control.

The cost of the acquisition is the aggregate fair value of the assets transferred, liabilities incurred and equity interests issued by the acquirer on the date of acquisition. In addition, the consideration transferred includes the fair value of any contingent consideration. After the acquisition date, the Group recognizes changes in fair value of the contingent consideration in the statement of income. Contingent consideration is stated as a financial liability in the statement of financial position.
On the acquisition date the acquirer recognizes a liability assumed in a business combination if there is a present obligation resulting from past events and its fair value can be reliably measured.

In a step acquisition, the difference between the fair value at the acquisition date of the Group's pre-existing equity rights in the acquiree and the carrying amount at that date is recognized in the statement of income under other operating revenue.

The Group recognizes goodwill at acquisition according to the fair value of the consideration transferred, including any amounts recognized in respect of rights that do not confer control in the acquiree as well as the fair value at the acquisition date of any pre-existing equity right of the acquirer in the acquiree, less the net amount of the identifiable assets acquired and the liabilities assumed. After initial recognition, goodwill is measured at cost less any accumulated impairment losses and is not systematically amortized. For assessment of impairment of goodwill, see section I below.

Costs associated with the acquisition that were incurred by the acquirer in the business combination such as finder's fees, advisory, legal, valuation and other professional or consulting fees, other than those associated with an issue of debt or equity instruments connected to the business combination, are recognized as expenses in the period the services are received.

(2) Subsidiaries

Subsidiaries are entities controlled by the Company. The financial statements of the subsidiaries are included in the condensed consolidated financial statements from the date that control commences until the date that control ceases. The accounting policies of the subsidiaries have been changed when necessary to align them with the policies adopted by the Group.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

A. Basis of consolidation (contd.)

(3) Jointly-controlled companies

The consolidated financial statements comprise the financial statements of the jointly-controlled company where the shareholders have a contractual arrangement that establishes common control and whose financial statements are consolidated with those of the Groups using the proportionate consolidation method. The Group combines in its consolidated financial statements its share of the assets, liabilities, income and expenses of the jointly-controlled company with similar items in its financial statements. Significant intragroup balances and transactions and profits or losses resulting from transactions between the Group and the jointly-controlled company are eliminated to the extent of the interest in the jointly-controlled company.

(4) Non-controlling interests

Non-controlling interests comprise the equity of a subsidiary that cannot be attributed, directly or indirectly, to the parent company and they include additional components such as share-based payments that will be settled with equity instruments of subsidiaries and share options of subsidiaries. Non-controlling interests that are instruments that give rise to a present ownership interest and entitle the holder to a share of net assets in the event of liquidation (for example, ordinary shares), are measured at the date of the business combination at fair value or at their proportionate interest in the identifiable assets and liabilities of the acquiree, on a transaction-by-transaction basis.

Profit or loss and any part of other comprehensive income are allocated to the owners of the Company and the non-controlling interests, even when the result is a negative balance of the non-controlling interests.

Transactions with non-controlling interests, while retaining control, are accounted for as equity transactions. Any difference between the consideration paid or received for change in non-controlling interests is recognized in capital reserve for transactions with non-controlling interests.

(5) Put option granted to non-controlling shareholders

The Group granted non-controlling shareholders a put option to sell part or all of their interests in several subsidiaries during a certain period. On the date of grant, the options that were granted to the non-controlling interests were classified as a financial liability. The Group recognizes, at each reporting date, financial liabilities measured by the estimated present value of the consideration when exercising the put option. If the option is exercised in subsequent periods, the consideration from the exercise is accounted for as sale of a liability. If the option expires, the expiry is accounted for as sale of the investment in subsidiary.

(6) Loss of control

Upon the loss of control, the Group derecognizes the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. If the Group retains any interest, including any loans in the previous subsidiary, then such interest, including the loans, is measured at fair value at the date that control is lost. Subsequently, the retained interest is accounted for on an equity basis, depending on the level of influence retained by the Group in the former subsidiary.

Loss of control of a subsidiary is accounted for as a discontinued operation, regardless of whether the Company retains a non-controlling interest in its former subsidiary (for example, when the investee becomes, after loss of control, an equity-accounted associate). The difference between the consideration and the fair value of the retained interest and the derecognized amounts are recognized in the statement of income under discontinued operations.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

A. Basis of consolidation (contd.)

(7) Special purpose entity

Special purpose entities (SPE) are consolidated if, based on an evaluation of the substance of their relationship with the Group and the SPEs' risks and rewards, the Group concludes that it controls the SPE's.

(8) Associates (accounted for by the equity method)

Associates are those entities in which the Group has significant influence, but not control, over financial and operating policy. Associates are accounted for using the equity method and are recognized initially at cost or at their fair value at the date control is lost. The investment includes goodwill calculated at the acquisition date and is presented net of accumulated impairment losses. The consolidated financial statements include the Group's share in the income and expenses of equity-accounted investees and adjustments to align the accounting policy with that of the Group, from the date that significant influence commences until the date that significant influence no longer exists. When the Group's share of losses exceeds its interest in an associate, the carrying amount of that interest is reduced to zero and the recognition of further losses is discontinued except to the extent that the Group has an obligation or has made payments on behalf of the associate.

When the Group holds additional long-term interests in the associate, which are a part of the Group's net investment in the associate, and when the Group's proportionate share in the additional interests is different to the Group's share in the equity of the associate, the Group recognizes its share in the additional losses of the associate at its proportionate share in the additional interests according to the percentage of the Company's participation in all the levels of the additional interests and according to the order of priority of the additional levels of interests. If, subsequently, the Group recognizes its share in the profits of the associate, the Company recognizes its share in the profits up to the amount of the cumulative profits previously recognized.
In respect of equity-accounted investments, goodwill is included in the carrying amount of the investment. Impairment loss for these investments is attributable to the entire investment and not to assets comprising the investment, such as goodwill. Therefore, the Group recognizes the reversal of losses recognized for equity-accounted investments when their recoverable amount increases.

(9) Transactions eliminated on consolidation

Intra-group balances and any unrealized income and expenses arising from intra-group transactions, are eliminated in the preparation of the consolidated financial statements. Unrealized gains arising from transactions with associates are eliminated against the investment to the extent of the Group's interest in these investments. Unrealized losses are eliminated in the same way as unrealized gains, but only to the extent that there is no evidence of impairment.

B. Foreign currency transactions

Transactions in foreign currency are translated into the functional currency of the Group at the exchange rate on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies on the reporting date are retranslated to the functional currency at the exchange rate at that date.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Financial instruments

(1) Non-derivative financial instruments

Non-derivative financial instruments comprise investments in shares and debentures, trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables, and debentures issued and loans taken by the Group.

Initial recognition of financial assets
The Group initially recognizes financial assets at the date the Group becomes a party to contractual provisions of the instrument, meaning the date that the Group fulfils its obligations under the contract.

Derecognition of financial assets
Financial assets are derecognized when the contractual rights of the Group to the cash flows from the asset expire, or the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred.

The Group classifies financial assets as follows:

Cash and cash equivalents
Cash comprises cash balances available for immediate use and call deposits. Cash equivalents comprise short-term highly liquid investments (with original maturities of three months or less) that are readily convertible into known amounts of cash and are exposed to insignificant risks of change in value.

Financial assets at fair value through profit or loss
A financial asset is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Upon initial recognition, attributable transaction costs are recognized in the statement of income as incurred. These financial assets are measured at fair value and changes therein are recognized in the statement of income.

Available-for-sale financial assets
The Group’s investments in shares and certain debt instruments are classified as available-for-sale financial assets. Subsequent to initial recognition, these investments are measured at fair value and changes therein, other than impairment losses and foreign currency differences are recognized directly in other comprehensive income and presented within equity in a reserve for available-for-sale financial assets. A dividend received for available-for-sale financial assets is recognized in the statement of income on the date the entity’s right to receive the dividend is established. When an investment is derecognized, the cumulative gain or loss in the reserve for available-for-sale financial assets is transferred to profit or loss.

Loans and receivables
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are recognized initially at fair value plus attributable transaction costs. Subsequent to initial recognition, loans and receivables are measured at amortized cost using the effective interest method, net of impairment losses.

Non-derivative financial liabilities
The Group has non-derivative financial liabilities as follows: debentures, loans and borrowings from banks, trade and other payables.
Financial liabilities are initially recognized at fair value plus any attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Financial instruments (contd.)

(1) Non-derivative financial instruments (contd.)

Non-derivative financial liabilities (contd.)
Financial liabilities are derecognized when the obligation of the Group, as specified in the agreement, expires or when it is discharged or cancelled.

An exchange of debt instruments having substantially different terms, between an existing borrower and lender are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability at fair value. Furthermore, a substantial modification of the terms of the existing financial liability or part of it is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The terms are substantially different if the discounted present value of the cash flows according to the new terms, including any commissions paid, less any commissions received and discounted using the original effective interest rate, is different by at least ten percent from the discounted present value of the remaining cash flows of the original financial liability.
In addition to the aforesaid quantitative criterion, the Group examines, inter alia, whether there have been changes also in various economic parameters inherent in the exchanged debt instruments, therefore exchanges of CPI-linked debt instruments with unlinked instruments are considered exchanges with substantially different terms even if they do not meet the aforementioned quantitative criterion.

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Group currently has a legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

(2) Derivative financial instruments

The Group holds derivative financial instruments to hedge its exposure to foreign currency, the CPI and copper prices. Hedge accounting is not applied to derivative instruments that economically hedge financial assets and liabilities. Derivative instruments are recognized initially at fair value; attributable transaction costs are recognized in the statement of income as incurred. Subsequent to initial recognition, derivative financial instruments are measured at fair value and the changes in fair value are recognized in the statement of income as incurred.

Embedded derivatives are separated from the host contract and accounted for separately if: (a) the economic characteristics and risks of the host contract and the embedded derivative are not closely related; (b) a separate instrument with the same terms as the embedded derivative would meet the definition of the derivative; (c) the combined instrument is not measured at fair value through profit or loss.
Changes in the fair value of separable embedded derivatives are recognized in the statement of income as financing income or expense as incurred.

(3) CPI-linked assets and liabilities that are not measured at fair value

The value of CPI-linked financial assets and liabilities, which are not measured at fair value, is revaluated in each period according to the actual increase in the CPI.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

D. Property, plant and equipment

(1) Recognition and measurement

Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses. Certain items of property, plant and equipment that were revalued to fair value on the date of transition to IFRS, were measured on the basis of their deemed cost, which is the fair value of those items at the transition date to IFRS (January 1, 2005), in accordance with the Group's assessments based on an external appraisal.

Cost includes expenditure that is directly attributable to acquisition of the asset. The cost of self-constructed assets includes the cost of materials, direct labor and financing costs as well as any other cost directly attributable to bringing the asset to the condition for its use intended by the management, and the costs of dismantling and removing the items and restoring the site on which they are located in cases where the Group has an obligation to vacate and restore the site. The cost of purchased software that is integral to the functionality of the related equipment is recognized as part of the cost of the equipment.

When major parts of the property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of the property, plant and equipment.

Changes in the obligation to dismantle the items and restore the site on which they are located, other than changes deriving from the passing of time, are added to or deducted from the cost of the asset in the period in which they occur. The amount deducted from the cost of the asset should not exceed its carrying amount, and any balance is recognized immediately in the statement of income.
Gains or losses on disposal of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of the asset, and are recognized net under "other income" in the statement of income.

(2) Subsequent costs

The cost of replacing part of an item of property, plant and equipment is recognized in the carrying amount of the item if it is probable that the future economic benefit embodied in the replaced item will flow to the Group and its cost can be measured reliably. The costs of day-to-day servicing are recognized in the statement of income as incurred.

(3) Capitalization of borrowing costs

Specific and non-specific borrowing costs are capitalized as qualifying assets throughout the period required for completion and construction until they are ready for their intended use. Non-specific borrowing costs are capitalized using a rate which is the weighted-average cost of the credit sources which were not specifically capitalized. Other borrowing costs are recognized in the statement of income as incurred.

(4) Depreciation

Depreciation is a systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount is the cost of the asset, or other amount substituted for cost, less its residual value.

Depreciation is recognized in the statement of income on a straight-line basis over the estimated useful life of each part of an item of property, plant and equipment, since this most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. Leased assets under finance lease agreements are depreciated over the shorter of the lease term and their useful lives. Depreciation of an asset starts when it is ready for use, meaning when it reaches the location and condition necessary for it to be capable of operating in the manner intended by management.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

D. Property, plant and equipment (contd.)

(4) Depreciation (contd.)
Leasehold improvements are depreciated over the shorter of the lease term, including the extension option held by the Group and intended to be exercised) and the expected life of the improvement.

The estimated useful lives for the current and comparative periods are as follows:

	Year	Principal depreciation rate (%)
NGN equipment	8	12
Digital switching equipment	4-10	25
Transmission and power equipment	5-10	20
Network equipment	5-25	4
Terminal equipment (cellular)	2-3	33
Subscriber equipment	5	20
Vehicles	7	15
Internet equipment	4-7	20
Office equipment	5-16	10
Electronic equipment, computers and internal communication systems	3-7	33
Cellular network	5-10	10
Buildings	25	4

Depreciation methods, useful lives and residual values are reviewed at least at each reporting year and adjusted as required.

E. Non-current assets held for sale

Non-current assets which are expected to be realized by way of sale rather than ongoing use are classified as assets held for sale. These assets are presented at the lower of the carrying amount and fair value, less selling costs. Impairment losses at the time of initial classification of an asset held for sale, and subsequent gains or losses resulting from remeasurement, are recognized in the statement of income. Gains are recognized up to the cumulative amount of impairment loss recorded in the past.

F. Intangible assets

(1) Goodwill
Goodwill that arises upon the acquisition of subsidiaries is included in intangible assets. For information on measurement of goodwill at initial recognition, see section A(1) above.

(2) Software development costs
Software development costs are recognized as an intangible asset only if the development costs can be measured reliably; the software is technically and commercially applicable; and the Group has sufficient resources to complete the development and intends to use the software. The costs recognized as an intangible asset include the cost of the materials, direct labor and overhead expenses directly attributable to preparation of the asset for its intended use. Other development costs are recognized in the statement of income as incurred.

Capitalized development costs are measured at cost less amortization and accumulated impairment losses.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

F. Intangible assets (contd.)

(3) Subscriber acquisition

Direct sale commissions paid to dealers and salespersons in respect of sales and upgrades to subscribers who have signed long-term commitments are recognized as an intangible asset. Amortization expenses are recognized in the statement of income over the period of the subscribers' commitments (between 12 and 36 months), on a straight line basis. When the subscriber terminates the agreement period, the balance of the asset is amortized immediately.

(4) Software

The Group's assets include computer systems consisting of hardware and software. Software that is an integral part of the hardware, which cannot function without the programs installed on it, is classified as property, plant and equipment. However, licenses for stand-alone software, which adds functionality to the hardware, is classified (mainly) as intangible assets. Software depreciation is recognized in the statement of income using the straight-line method over the estimated useful life of the asset.

(5) Rights to frequencies

Rights to frequencies refer to Pelephone's rights to cellular communication frequencies according to a Ministry of Communications tender. Depreciation of the asset is recognized in the statement of income on the straight line method over the license term, which is 13 years and 7 months starting from the date of use of the frequencies.

(6) Other intangible assets

Other intangible assets acquired by the Group, which have a definite useful life, are measured at cost less amortization and accumulated impairment losses.

(7) Subsequent expenditure

Subsequent expenditure is recognized as an intangible asset only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure, including expenditure relating to generated goodwill and brands, is recognized in the statement of income as incurred.

(8) Amortization

Amortization is the systematic allocation of the amortizable amount of an intangible asset over its useful life. The amortizable amount is the cost of an asset, or another amount substituted for the cost, less its residual value.

Amortization, except for goodwill, is recognized in the statement of income on a straight-line basis over the estimated useful life of the intangible assets, from the date on which the assets are available for use. Goodwill is not systematically amortized but is tested for impairment.
Estimated useful lives for the current and comparative periods are as follows:

Capitalized development costs	4-7 years
Other rights	3 - 10 years, depending on the useful life
Subscriber acquisition costs	Depending on the contractual commitment with the subscriber
Frequency usage right	Over the term of the license for 13.6 years starting from the date of use of the frequencies
Computer programs and software licenses	Over the term of the license or the estimated time of use of the program

Amortization methods and useful lives are reviewed at each reporting date and adjusted if appropriate.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

G. Leased assets

Leases where the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to the asset.

At inception or upon reassessment of an arrangement, the Group determines whether such an arrangement is or contains a lease. A specific asset is the subject of a lease if fulfillment of the arrangement is dependent on the use of that specified asset or assets. An arrangement conveys the right to use the asset if the arrangement conveys to the Group the right to control the use of the asset. At inception or upon reassessment of the arrangement, the Group separates payments and other consideration required by such an arrangement into those for the lease and those for other elements on the basis of their relative fair values.

Transactions for acquiring an indefeasible right of use (IRU) of seabed cable capacities are accounted for as service transactions. The prepaid expense is amortized on a straight-line basis as stated in the agreement and no more than the expected estimated useful life of those capacities.

Other leases are operating leases and the leased assets are not recognized in the Group's statement of financial position. For further information regarding the change in accounting policies relating to the classification of leases of land from the Israel Land Administration, see Note 2(H).

H. Inventory

Inventories are measured at the lower of cost and net realizable value. The cost of inventories is based on the moving average principle. Slow-moving inventory of terminal equipment, accessories and spare parts are stated net of the provision for impairment.

The inventories of a subsidiary include terminal equipment and accessories intended for sale and service, as well as spare parts used for repairs in the repair service it provides to its customers.

I. Impairment

(1) Financial assets

The Group tests a financial asset for impairment when objective evidence indicates that one or more loss events have had a negative effect on the estimated future cash flows of that asset.

When testing available-for-sale financial assets that are equity instruments for impairment, the Group also examines the difference between the fair value of the asset and its original cost, the length of time the fair value of the asset is lower than its original cost and changes in the technological, economic or legal environment or in the market environment in which the issuer of the instrument operates. In addition a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount and the present value of the estimated future cash flows, discounted at the original effective interest rate. An impairment loss in respect of an available-for-sale financial asset is calculated by reference to its fair value.

Significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed for impairment collectively, in groups that share similar credit risk characteristics. The financial statements include specific provisions and Group provisions for doubtful debts, which properly reflect, in the estimation of the management, the loss inherent in debts for which collection is in doubt.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

I. Impairment (contd.)

(1) Financial assets (contd.)

All impairment losses are recognized in the statement of income. Any cumulative loss in respect of an available-for-sale financial asset recognized previously in equity is transferred to the statement of income.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognized. For financial assets measured at amortized cost and available-for-sale financial assets that are debt securities, the reversal is recognized in the statement of income. For available-for-sale financial assets that are equity securities, the reversal is recognized directly in other comprehensive income.

(2) Non-financial assets

The carrying amounts of the Group's non-financial assets, other than inventories and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated. On January 1, 2005, the date of transition to IFRS, the Group reviewed goodwill for impairment. In subsequent periods, the Group assesses the recoverable amount of goodwill and of assets which are unavailable for use once a year, or more frequently if there are indications of impairment.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its net selling price (fair value less costs to sell). In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For the purpose of impairment testing, the assets are grouped together into the smallest group of assets that generates cash from continuing usage, that are largely independent of other assets or groups of assets ("cash-generating unit"). For purposes of goodwill impairment testing, cash-generating units to which goodwill has been allocated are aggregated so that the level at which impairment testing is performed reflects the lowest level at which goodwill is monitored for internal reporting purposes, but in any event is not larger than an operating segment. Goodwill acquired in a business combination, for the purpose of impairment testing, is allocated to cash-generating units that are expected to generate benefits from the synergies of the combination.

Impairment losses are recognized if the carrying amount of an asset or its cash-generating unit exceeds its estimated recoverable amount. Impairment losses are recognized in the statement of income. Impairment losses recognized in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amounts of the other assets in the cash-generating unit on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognized in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

Goodwill that forms part of the carrying amount of an investment in an associate is not recognized separately, and therefore is not tested for impairment separately. If objective evidence indicates that the value of the investment may have been impaired, the investment is tested for impairment.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

J. Employee benefits

(1) Post-employment **benefits**

The Group has a number of post-employment benefit plans. The plans are usually financed by deposits with insurance companies and they are classified as defined contribution plans and defined benefit plans.

A. Defined contribution plans

The Group's obligations for contributions to defined contribution pension plans are recognized as an employee benefit expense in the statement of income in the periods during which services are rendered by employees. See Note 17A below.

B. Defined benefit plans

The Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is stated at present value and the fair value of any plan assets and the cost of past service not yet recognized are deducted. The discount rate is the yield at the reporting date on government bonds denominated in the same currency that have maturity dates approximating the terms of the Group's obligation. The calculation is performed by a qualified actuary. See Note 17B below.

When the calculation results in a net asset for the Group, an asset is recognized up to the net present value of economic benefits received in the form of a refund from the plan or a reduction in future contributions to the plan.

Gains or losses resulting from curtailments or settlements of a defined benefit plan are recognized in the statement of income. Such gains or losses include any resulting change in the present value of the obligation.

The Group has executive insurance policies that were issued before 2004 according to which the profit in real terms accumulated on the severance pay component will be paid to the employees upon their retirement. In respect of such policies, plan assets include both the balance of the severance pay component and the balance of the profit in real terms (if any) on the severance pay deposits that accumulated until the reporting date, and are presented at fair value.

These plan assets are for a defined benefit plan that includes two liability components: The defined benefit plan for compensation, which is calculated actuarially as aforesaid, and liability for payment of any retained earnings accumulated at the date of severance. This component is measured at the balance of the actual profit in real terms that accumulated at the reporting date.

The Group recognizes immediately, directly in retained earnings through other comprehensive income, all actuarial gains and losses arising from defined benefit plans.

(2) Other long-term employee benefits

The Group's net obligation in respect of long-term employee benefits other than pension plans is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The amount of these benefits is stated at its present value. The discount rate is the yield at the reporting date on government bonds denominated in the same currency, that have maturity dates approximating the terms of the Group's obligations. The calculation is performed using the projected unit credit method. Any actuarial gains or losses are recognized in the statement of income in the period in which they arise.

(3) Benefits for early retirement and dismissal

Employment termination benefits are recognized as an expense when the Group is committed demonstrably, without realistic possibility of withdrawal, to a formal detailed plan to terminate employment before the normal retirement date. Termination benefits for voluntary redundancies are recognized as an expense if the Group has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

J. Employee benefits (contd.)

(4) Short-term benefits

A liability is recognized for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably. In the statement of financial position the employee benefits are classified as current benefits or as non-current benefits according to the time the liability is due to be settled.

(5) Share-based payments

The fair value on the grant date of options for Company shares granted to employees is recognized as a salary expense with a corresponding increase in equity over the period during which the employee becomes entitled to the options. The amount recognized as an expense is adjusted to reflect the actual number of share options that are expected to vest.

For share-based payment awards with non-vesting conditions, the fair value of the share-based payment awards is measured to reflect such conditions, and therefore the Group recognized an expense in respect of the awards whether or not the conditions have been met.

The fair value of the amount payable to employees in respect of share-based payments, which are settled in cash, is recognized as an expense with a corresponding increase in liabilities, over the period that the employees become entitled to payment. The liability is remeasured at each reporting date until the settlement date. Any changes in the fair value of the liability are recognized as an expense or income in the statement of income.

K. Provisions

A provision is recognized if, as a result of a past event, the Group has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows. The carrying amount of the provision is adjusted each period to reflect the time that has passed and is recognized as a financing expense.

(1) Legal claims

Contingent liabilities are accounted for according to IAS 37 and its related provisions. Accordingly, the claims are classified by likelihood of realization of the exposure to risk, as follows:

A. More likely than not – more than 50% probability
B. Possible – probability higher than unlikely and less than 50%C. Remote – probability of 10% or less

For claims which the Group has a legal or constructive obligation as a result of a past event, which are more likely than not to be realized, the financial statements include provisions which, in the opinion of the Group, based, inter alia, on the opinions of its legal advisers retained in respect of those claims, are appropriate to the circumstances of each case, despite the claims being denied by the Group companies. There are also a few legal proceedings, received recently, for which the risks cannot be assessed at this stage, therefore no provisions have been made.

Note 18 describes the amount of additional exposure due to contingent liabilities that are likely to be realized and contingent liabilities that are unlikely to be realized, however the maximum possible loss from the claim could place the continuation of the Group's operations at risk in the current format.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

K. Provisions (contd.)

(2) Onerous contracts
A provision for onerous contracts is recognized when the benefits expected to be derived by the Group from the contracts are lower than the unavoidable cost of meeting its obligations according to the contracts. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract.

(3) Site dismantling and clearing costs
A provision in respect of an obligation to dismantle and clear sites is made in accordance with IAS 37. The provision is made for those rental agreements in which the Group has undertaken to restore the rental property to its original state at the end of the rental period, after dismantling and transferring the site, and restoring it as necessary.

(4) Warranty
A subsidiary recognized a provision for warranty in respect of first-year insurances for cellular handsets. The warranty is limited to technical malfunctions defined by the subsidiary, and does not include warranty as a result of customer damages. However, an asset exists in respect of the manufacturer's warranty for those handsets, which is limited to technical malfunctions defined by the manufacturer.

L. Revenue

The Group's revenues are mainly composed of revenues for fixed-line communication services, cellular services, international communication services, customer center services, communication services for other operators, sales and installation of communication equipment and internet services. Revenue is measured at the fair value of the consideration received or receivable, net of returns, trade discounts and volume rebates.

(1) Equipment sales
Revenue from sales of terminal equipment is recognized in the statement of income when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably and the Group companies have no continuing involvement with the goods.

Revenue from the sale of terminal equipment to subscribers in long-term credit arrangements is recognized upon delivery to the customer at the present value of the future cash flow expected from them, at the market interest rate for transactions of this kind. Financing income in respect of these transactions is recognized in the statement of income over the period of the installments by the interest method.

(2) Revenue from services
Revenue from services rendered is recognized in the statement of income proportionately over the term of the agreement or upon providing the service if the flow of the economic benefits associated with providing the service is likely. Revenue from calls, including revenue from prepaid call cards, is recognized when the call is made by the customer.

(3) Multi-component sales agreements
For multi-component transactions in which terminal equipment is sold together with the customer's undertaking to receive services, the Group applies the relative fair value method. Allocation of the revenue to a supplied component is limited to the amount of the consideration that is not contingent upon the supply of additional components.

(4) Reporting of gross or net revenues
When the Group acts as an agent or intermediary without bearing the risks and rewards deriving from the transaction, its revenue is recognized on a net basis. However, when the Group acts as a main supplier and bears the risks and rewards deriving from the transaction, its revenue is recognized on a gross basis.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

M. Financing income and expense

Financing income comprises interest income from deposits, dividend income, income interest accrued using the effective interest method in respect of the sale of terminal equipment in installments, gains on the disposal of available-for-sale financial assets, changes in the fair value of financial assets at fair value through profit or loss, foreign currency gains and gains on derivative instruments that are recognized in the statement of income (except for gains from hedging copper prices recognized in other operating income). Interest income is recognized as it accrues using the effective interest method. Dividend income is recognized on the date that the Group's right to receive payment is established

Changes in the fair value of financial assets at fair value through the statement of income also include income from dividends and interest.

Financing expenses comprise interest expense on borrowings, debentures issued, commissions paid, changes in time value of provisions, changes in the fair value of financial assets at fair value through the statement of income, impairment losses recognized on financial assets (except for a provision for doubtful debts, which is recognized under operating and general expenses), financing expenses for legal claims and losses on hedging instruments that are recognized in the statement of income.

Foreign currency gains and losses are reported on a net basis as either financing income or financing expenses depending on whether foreign currency movements are in a net gain or net loss position.

N. Income tax expense

Income tax expense comprises current and deferred tax. Income tax expenses are recognized in the statement of income except to the extent that it relates to a business combination, or are recognized directly in equity or in other comprehensive income to the extent they relate to items recognized directly in equity or in other comprehensive income.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and include changes in the tax payments relating to prior years.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The Group does not recognize deferred taxes for the following temporary differences: initial recognition of goodwill, initial recognition of assets and liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss, carry-forward losses that are not expected to be utilized in the foreseeable future, and differences arising from investment in subsidiaries if it is probable that they will not reverse in the foreseeable future.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. The Group sets off deferred tax assets and liabilities if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for carry-forward losses, tax benefits and deductible temporary differences, to the extent that it is probable that future taxable profits will be available against which they can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

O. Earnings per share

The Group presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the year. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, which comprise warrants and share options granted to employees.

P. Segment reporting

An operating segment is a component of the Group that meets three conditions as follows:

(1) It engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components.

(2) Its operating results are reviewed regularly by the Group's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance.

(3) Separate financial information is available in its respect.

Q. Transactions with a controlling shareholder

Assets and liabilities included in a transaction with a controlling shareholder are measured at fair value on the date of the transaction. As the transaction is on the equity level, the Company includes the difference between the fair value and the consideration from the transaction in its equity.

R. Dividends declared subsequent to the reporting date

An obligation relating to a dividend proposed or declared after the reporting date is recognized only in the period in which the declaration was made.

S. New standards and interpretations not yet adopted

(1) IFRS 9 (2010) – Financial Instruments ("the Standard"). This Standard is one of the stages in a comprehensive project to replace IAS 39 – Financial Instruments: Recognition and *Measurement* ("IAS 39") and it replaces the requirements included in IAS 39 regarding the classification and measurement of financial assets and financial liabilities.
In accordance with the Standard, there are two principal categories for measuring financial assets: amortized cost and fair value, with the basis of classification for debt instruments being the entity's business model for managing financial assets and the contractual cash flow characteristics of the financial asset.
The Standard generally preserves the instructions regarding classification and measurement of financial liabilities that are provided in IAS 39.
The Standard is effective for annual periods beginning on or after January 1, 2013. Early application is permitted, subject to disclosure and subject to parallel adoption of other IFRSs, set out in the appendix to the Standard. The Standard is to be applied retrospectively other than in a number of exceptions. The Group is examining the effect of adopting the Standard on the financial statements.

(2) IAS 24 (2009) *Related Party Disclosures* ("the Standard"). The new standard includes changes in the definition of a related party and changes with respect to disclosures required by entities related to government. The Standard is to be applied retrospectively for annual periods beginning on or after January 1, 2011. The Group is in the process of reassessing its relationships with related parties for the purpose of examining the effects of adopting the Standard on its financial statements.

NOTE 4 – DETERMINATION OF FAIR VALUE

A number of the Group's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and / or disclosure purposes based on the following methods. Further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

A. Investment in securities

The fair value of investments in shares and debentures is determined by reference to their quoted closing bid price at the reporting date or with consideration of available market information (such as the use of interest curves).

B. Trade receivables

The fair value of trade receivables is based on the present value of the future cash flows, discounted at the market interest rate on the transaction date. Subsequent to initial recognition, the fair value of trade and other receivables, for disclosure purposes only, is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date.

C. Derivatives

The fair value of forward exchange contracts, the CPI or copper prices and foreign currency options is based on their quoted price, if available. If a quoted price is not available, then fair value is estimated by discounting the difference between the contractual forward price and the current forward price for the residual maturity of the contract, using an appropriate interest rate.

D. Property, plant and equipment

Some items of property, plant and equipment were revalued on the date of transition to IFRS (January 1, 2005). The deemed cost of the items is calculated on the basis of a valuation by an external appraiser using the depreciated replacement cost method.

E. Intangible assets

The fair value of a brand acquired in a business combination is based on the relief from royalty methodology, according to which the brand value is estimated by discounting the appropriate amount of the royalty payments, which the user of the asset would pay for the use of the asset had it not owned the asset. The fair value of customer relations, order backlog and technology knowhow acquired in a business combination is determined using the multi-period excess earnings methodology.

F. Non-derivative financial liabilities

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date.

G. Share-based payment transactions

The fair value of employee share options and of cash-settled share based payments is measured using the Black-Scholes model. The assumptions of the model include the share price on the date of measurement, the exercise price of the instrument, expected volatility (based on the weighted average of historical volatility, adjusted for changes expected due to publicly available information), the projected useful life of the instruments (based on past experience and the general behavior of the option-holders), expected dividends, and the risk-free interest rate (based on government bonds). Non-vesting conditions are taken into account in the calculation of fair value. See also Note 27.

NOTE 5 – ACQUISITION OF SUBSIDIARIES

A. Walla! Communications Ltd. (Walla)

In April 2010, Bezeq International, a wholly owned subsidiary, acquired from Haaretz Newspaper Publishing Ltd. 32.55% of the issued and paid up share capital of Walla, in an off-floor transaction, for NIS 89 million. This acquisition is incremental to the 34.2% of Walla!'s shares held by Bezeq International prior to that date. Following the acquisition, Bezeq International is the controlling shareholder in Walla and as from April 25, 2010, Bezeq International consolidates Walla in its financial statements.

In September 2010, Bezeq International acquired additional shares of Walla (representing 5% of the issued and paid up share capital of Walla) through a special tender offer, at a price of NIS 6 per share and a total of NIS 13.6 million.
On September 21, 2010, after receiving approval from the Antitrust Commissioner for the merger with Walla, the Company acquired from Bezeq International all the shares held by Bezeq International, representing 71.76% of the issued and paid up share capital of Walla, for NIS 196 million.

The contribution of Walla to profit and revenue as from the beginning of the consolidation and through to December 31, 2010 amounted to NIS 2 million and NIS 131 million, respectively. Had the acquisition taken place on January 1, 2010, the revenue in the consolidated statement of income and the consolidated profit in the period would not have been materially different. Management assumes that the fair value adjustments at the acquisition date, which were determined, are fundamentally the same as the adjustments that would have been received had the acquisition taken place on January 1, 2010. As from the date of consolidation, the operations of Walla are included under other segments (see Note 29). In accordance with IFRS, the holdings in Walla prior to the acquisition were estimated at the share price which was included in the acquisition transaction. As a result, a profit of NIS 57 million was included under other operating revenue in the consolidated financial statements.

Acquisition of the Group's assets and liabilities at the acquisition date had the following effect:

	Values recognized at the acquisition date
	NIS millions
Identifiable assets and liabilities, net	111
Prior equity rights in an acquiree	(94)
Goodwill upon acquisition	70
Non-controlling interests	(57)
Cost of business combination	30
Proceeds paid in cash	(89)
Cash acquired	59
Cash paid, net	(30)

The Group elected to measure non-controlling interests arising from acquisition of control in Walla according to their proportionate share in the net identifiable assets of Walla.

NOTE 5 – ACQUISITION OF SUBSIDIARIES

B. Coral Tell Ltd.

In September 2010, Walla entered into an agreement with the shareholders of Coral-Tell Ltd. ("Yad2"), which operates an online classified ads platform. According to the agreement, Walla will acquire 75% of the share capital of Yad2 for NIS 117.5 million, plus an additional sum to be paid to the sellers, based on the total working capital of Yad2 and subject to adjustments. The deal was finalized on September 2, 2010.
According to the acquisition agreement, Walla has a call option to acquire all the non-controlling interests at a price based on the value of Yad2 that is not less than a minimum of NIS 125 million and not more than NIS 200 million. Additionally, Walla granted a put option for all of Walla shares, at a fixed price of NIS 125 million based on the value of Yad2, to non-controlling interests in Yad2. The options are exercisable after three years from finalization of the transaction for a period of one year.
In addition, according to the purchase agreement, Walla and the non-controlling interest in Yad2 agreed to distribute a maximum dividend.
Due to the call and put options, the business combination was accounted for as acquisition of 100% of the acquired rights and the consideration for the business combination includes the fair value of liability expected to be paid to the non-controlling interests in Yad 2.

Walla carried out a temporary allocation of the acquisition cost in relation to the fair value of the assets and liabilities that were acquired in the business combination. The main intangible assets arising from acquisition are brand and goodwill. The brand is expected to be amortized on a straight line basis over nine years. The fair value of the acquired assets and liabilities is adjustable up to twelve months from the acquisition date. If relevant, at the final attribution date, adjustment will be made by restatement of the comparative information previously reported according to the temporary allocation.

Had the acquisition taken place at the beginning of the year, the revenue in the consolidated statement of income and the consolidated profit in the period would not have been materially different.

Acquisition of the Group's assets and liabilities at the acquisition date had the following effect:

	Values recognized at the acquisition date
	NIS millions
Identifiable assets and liabilities, net	81
Goodwill upon acquisition	77
Put option for non-controlling interests	(38)
Payables for investment and media services	(5)
Cost of business combination	115
Proceeds paid in cash	(116)
Cash acquired	1
Cash paid, net	(115)

NOTE 6 – CASH AND CASH EQUIVALENTS

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Bank balances	**55**	64
Call deposits	**310**	516
	365	580

In 2010, the effective interest rate for call deposits was 1.5%-1.59% (in 2009, 0.74%-0.8%). For deposits, the average maturity period was 4-7 days (in 2009, 6-8 days). See also Note 32.

NOTE 7 – INVESTMENTS, INCLUDING DERIVATIVES

A. Categories of financial assets

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Current investments		
Derivative instruments	**5**	13
Financial assets held for trading (monetary reserve)	**-**	141
Other investments	**2**	-
	7	154
Non-current investments		
Bank deposit for providing loans to employees (2)	**83**	83
Available-for-sale financial assets (1)	**31**	37
Derivative iinstruments	**10**	10
Other investments	**5**	-
	129	130
	136	284

(1) Sensitivity analysis – price risk of available-for-sale assets (shares and options)
The strengthening of the shekel compared to the dollar by 10% would increase the value of the available-for-sale financial assets and increase the equity by NIS 3 million after tax) (in 2009, an increase of NIS 2.7 million after tax). A similar change in the opposite direction would reduce equity by the same amount.

(2) The deposit serves as a security for providing bank loans to Company employees. The deposit is unlinked and the effective interest rate of the deposit at December 31, 2010 is 2.15% (in 2009, 2.73%). The Company is liable for the loans to employees. The deposit is stated at its present value, taking into account the loan repayment schedule, based on a weighted average discount rate of 3.28% (in 2009, 3.53%).

NOTE 7 – INVESTMENTS, INCLUDING DERIVATIVES

B. Analysis of forecasted maturity dates

	2011	2012	Undetermined	Total
	NIS millions	NIS millions	NIS millions	NIS millions
Investments in available-for-sale financial assets	**-**	**-**	**31**	**31**
Bank deposit for providing loans to employees	**-**	**-**	**83**	**83**
Derivative instruments	**5**	**10**	**-**	**15**
Other investments	**2**	**-**	**5**	**7**
	7	**10**	**119**	**136**

NOTE 8 – TRADE AND OTHER RECEIVABLES

A. Composition of trade and other receivables

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Trade receivables		
Outstanding debts	**719**	681
Credit cards and checks receivable	**554**	492
Unbilled receivables	**413**	398
Current maturities of long-term receivables	**992**	850
Related and interested parties	**23**	70
	2,701	2,491
Receivables		
Prepaid expenses	**119**	88
Other receivables	**105**	83
	224	171
Long-term trade and other receivables		
Trade receivables – open debts (1)	**954**	823
Trade receivables - associate	**44**	8
Long term receivables	**116**	56
	1,114	887
	4,039	3,549

Trade and other receivables include NIS 38 million for trade and other receivables denominated in the US dollar (in 2009, NIS 64 million).

The long-term trade and other receivables are repayable up to 2015.

(1) For discount interest rates, see Note 32.

NOTE 8 – TRADE AND OTHER RECEIVABLES (CONTD.)

B. Aging of trade receivables at the reporting date:

	December 31, 2010		December 31, 2009	
	Trade receivables (gross)	Provision for doubtful debts	Trade receivables (gross)	Provision for doubtful debts
	NIS millions	NIS millions	NIS millions	NIS millions
Not past due	**3,423**	**(39)**	2,958	(17)
Past due up to one year	**294**	**(80)**	354	(97)
Past due one to two years	**127**	**(73)**	127	(62)
Past due more than two years	**176**	**(129)**	165	(106)
	4,020	**(321)**	3,604	(282)

C. Change in provision for doubtful debts during the year:

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Balance at January 1	**282**	311
Additions in respect of a business combination	**5**	-
Derecognition of discontinued operations	**-**	(9)
Impairment loss recognized	**62**	55
Lost debts	**(28)**	(75)
Balance at December 31	**321**	282

NOTE 9 – INCOME TAX

A. General

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Current tax expense			
For the current period	**823**	671	526
Adjustments for prior years, net	**-**	(30)	(4)
	823	641	522
Deferred tax expense			
Creation and reversal of temporary differences	**114**	136	197
Effect of change in tax rates	**(5)**	30	-
	109	166	197
Income tax expenses	**932**	807	719

NOTE 9 – INCOME TAX (CONTD.)

B. Reconciliation between the theoretical tax on the pre-tax profit and the tax expense

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Profit before income tax	**3,374**	2,969	2,505
Statutory tax rate	**25%**	26%	27%
Income tax at the statutory tax rate	**844**	772	676
Differences in the tax rate	**(8)**	60	13
Expenses not recognized for tax purposes	**31**	(4)	35
Adjusted tax calculated for the Company's share in equity-accounted investees	**65**	9	(1)
Taxes for previous years	**-**	(30)	(4)
	932	807	719

C. Unrecognized deferred tax liabilities

The calculation of deferred taxes does not take into account the taxes that would be applicable in the case of sale of investments in subsidiaries and associates, since the Group intends to retain the investment. Deferred taxes in respect of a distribution of profit in subsidiaries and associates were also not taken into account since the dividends are not taxable.

D. Unrecognized deferred tax assets

Deferred tax assets have not been recognized in respect of carry-forward capital losses for tax purposes as at December 31, 2010, in the amount of NIS 57 million.

Deferred tax assets relating to carry-forward losses and tax benefits were not recognized because their utilization in the foreseeable future is not probable. The deductible temporary differences and tax losses do not expire under current tax legislation. Deferred tax assets have not been recognized in respect of these items since it is not probable that future taxable profit will be available against which the Group can utilize the benefits.

NOTE 9 – INCOME TAX (CONTD.)

E. Recognized tax assets and deferred tax liabilities

Deferred tax assets and tax liabilities are attributed to the following items:

	Assets		Liabilities		Net	
	2010	**2009**	**2010**	**2009**	**2010**	**2009**
	NIS millions	**NIS millions**	**NIS millions**	**NIS millions**	**NIS millions**	**NIS millions**
Property, plant and equipment	**-**	-	**149**	130	**(149)**	(130)
Doubtful debts	**54**	47	**-**	-	**54**	47
Employee benefit plan	**264**	338	**-**	-	**264**	338
Share-based payments	**20**	33	**-**	-	**20**	33
Provisions	**29**	38	**-**	-	**29**	38
Carry-forward tax losses	**2**	2	**-**	-	**2**	2
Other assets and deferred expenses	**6**	6	**55**	12	**(49)**	(6)
	375	464	**204**	142	**171**	322

F. Changes in temporary differences during the year

	Balance at January 1, 2009	Changes recognized in profit or loss	Changes recognized in capital	Balance at December 31, 2009	Changes recognized in profit or loss	Changes recognized in capital	Business combinations	Balance at December 31, 2010
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Property, plant and equipment	(100)	(30)	-	(130)	**(19)**	**-**	**-**	**(149)**
Doubtful debts	47	-	-	47	**7**	**-**	**-**	**54**
Employee benefit plans	366	(31)	3	338	**(70)**	**(4)**	**-**	**264**
Share-based payments	122	(89)	-	33	**(13)**	**-**	**-**	**20**
Provisions	48	(10)	-	38	**(9)**	**-**	**-**	**29**
Carry-forward tax losses	4	(2)	-	2	**-**	**-**	**-**	**2**
Other assets and deferred expenses	(2)	(4)	-	(6)	**(5)**	**(1)**	**(37)**	**(49)**
	485	(166)	3	322	**(109)**	**(5)**	**(37)**	**171**

NOTE 9 – INCOME TAX (CONTD.)

G. Amendments to the Income Tax Ordinance

Current and deferred tax balances for the periods reported in these financial statements are calculated in accordance with the new tax rates specified in the Economic Efficiency Law of July 14, 2009. The tax rates are as follows: 2009 tax year – 26%; 2010 tax year – 25%; 2011 tax year – 24%; 2012 tax year – 23%; 2013 tax year - 22%; 2014 tax year – 21%; 2015 tax year - 20%; and from the 2016 tax year onwards – 18%.

Current and deferred tax balances as at December 31, 2010 are calculated in accordance with the tax rates specified above.

H. Final tax assessments

(1) The Company has received final tax assessments up to and including 2004.

(2) Bezeq International has received final tax assessments up to and including 2005.

(3) Pelephone, Walla and Bezeq Online have received final tax assessments up to and including 2006.

NOTE 10 – PROPERTY, PLANT AND EQUIPMENT

Composition and Activity:

	Land and buildings	Switching, transmission, power, cellular and satellite equipment	Network equipment	Subscriber equipment	Vehicles	Office equipment and computers	Total
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Cost or deemed cost							
Balance as at January 1, 2009	2,209	4,770	12,450	3,544	84	1,353	24,410
Additions	54	558	346	207	37	92	1,294
Disposals (D, below)	(180)	(376)	(6)	(217)	(24)	(110)	(913)
Transfer to assets held for sale	(10)	-	-	-	-	-	(10)
Discontinued operations	(40)	(232)	-	(2,928)	-	(74)	(3,274)
Balance as at December 31, 2009	2,033	4,720	12,790	606	97	1,261	21,507
Balance as at January 1, 2010	2,033	4,720	12,790	606	97	1,261	21,507
Additions	**64**	**471**	**525**	**106**	**78**	**84**	**1,328**
Disposals (D, below)	**(92)**	**(223)**	**(367)**	**(256)**	**(5)**	**(9)**	**(952)**
Transfer from assets held for sale	**40**	**-**	**-**	**-**	**-**	**-**	**40**
Addition in respect of a business combination	**10**	**-**	**-**	**-**	**-**	**57**	**67**
Balance as at December 31, 2010	**2,055**	**4,968**	**12,948**	**456**	**170**	**1,393**	**21,990**
Depreciation and impairment losses							
Balance at January 1, 2009	1,583	2,515	10,226	2,752	60	1,066	18,202
Depreciation for the year	74	631	281	124	8	97	1,215
Depreciation from discontinued operations	2	10	-	109	-	7	128
Disposals (D, below)	(140)	(376)	(3)	(206)	(24)	(110)	(859)
Transfer to assets held for sale	(11)	-	-	-	-	-	(11)
Discontinued operations	(29)	(188)	-	(2,331)	-	(48)	(2,596)
Balance as at December 31, 2009	1,479	2,592	10,504	448	44	1,012	16,079
Balance as at January 1, 2010	1,479	2,592	10,504	448	44	1,012	16,079
Depreciation for the year	**59**	**607**	**299**	**32**	**14**	**103**	**1,114**
Disposals (D, below)	**(73)**	**(222)**	**(343)**	**(246)**	**(4)**	**(9)**	**(897)**
Transfer from assets held for sale	**30**	**-**	**-**	**-**	**-**	**-**	**30**
Additions in respect of a business combination	**7**	**-**	**-**	**-**	**-**	**47**	**54**
Balance as at December 31, 2010	**1,502**	**2,977**	**10,460**	**234**	**54**	**1,153**	**16,380**
Carrying amount							
January 1, 2009	626*	2,255	2,224	792	24	287	6,208
December 31, 2009	554*	2,128	2,286	158	53	249	5,428
December 31, 2010	**553**	**1,991**	**2,488**	**222**	**116**	**240**	**5,610**

* Retrospective application by restatement, see Note 2H

NOTE 10 – PROPERTY, PLANT AND EQUIPMENT (CONTD.)

A. **Determination of fair value as deemed cost:** Certain items of property, plant and equipment from switching, transmission and power equipment, mainly switching equipment, which were revalued to fair value on the date of transition to IFRS, were measured on the basis of their deemed cost, which was based on their fair value on the transition date (January 1, 2005), as assessed by the Group based on the valuation of an external appraiser.

B. **Residual value:** The residual value of the Group's copper cables is assessed at the end of each reporting year. The residual value is NIS 689 million and NIS 598 million as at December 31, 2010 and December 31, 2009, respectively. The increase in residual value will decrease the depreciation expense of the Company by NIS 10 million in 2011.

C. **Cost of dismantling and removal of assets:** The cost of items of property, plant and equipment includes dismantling and removal costs, as well as site restoration costs where the Group has an obligation. These costs are depreciated according to the expected useful life of the sites. In 2010, the Group recognized, as part of the cost of property, plant and equipment, costs of NIS 5 million for dismantling and removal of assets (in 2009, NIS 5 million).

D. Property, plant and equipment in the Group is derecognized at the end of each year upon reaching full depreciation, except for land, buildings, vehicles and copper cables, which are derecognized upon their sale. In 2010, the Group derecognized fully depreciated property at a cost of NIS 847 million (in 2009 NIS 661 million).

E. The cost includes NIS 3 million in the Group, representing finance expenses which were capitalized in the reporting period in respect of loans and credit in the construction period and calculated at an average interest rate of 4.6% per year (in the prior year, 6.3%).

F. For details of installation of the UMTS/HSPA network, see Note 19E. Depreciation commenced in January 2009, as the network was readied and became available for use.

G. In July 2008, the Company launched the NGN project to replace the existing network. The Company expects that most of the deployment will be completed by the end of 2011.

H. The Group companies reviewed the useful life of the property, plant and equipment through the depreciation committee, in order to determine the estimated useful life of their equipment. The findings of the committees do not indicate a need to change the estimated useful life of the property, plant and equipment.

J. Most of the real estate assets used by the Company were transferred to it by the State of Israel, according to the provisions in the asset transfer agreement signed between the Company and the State on January 31, 1984. Some of these assets were leased for 49 years, with an option for an extension for another 49 years, and others were rented for two years, renewable each time for another two years.

On May 15, 2003, the Company signed a settlement agreement with the Government of Israel on behalf of the State and Israel Lands Administration, which regulated the dispute between them in the matter of the Company's rights in the various real estate assets which were transferred to the Company when it commenced operation in 1984, under the asset transfer agreement.
The rights are amortized over the course of the lease period.

At the reporting date, there are agreements to purchase property, plant and equipment amounting to NIS 300 million (in 2009, NIS 379 million).

K. See Note 20 for liens.

NOTE 11 – INTANGIBLE ASSETS

	Goodwill	Computer software and licenses and discounted development costs	Subscriber acquisition	Right of use in communication and cellular frequencies (2)	Others	Total
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Cost						
Balance at January 1, 2009	1,799	1,501	379	422	63	4,164
Acquisitions or additions from independent development	-	198	95	2	1	296
Disposals (1)	-	(197)	(46)	-	-	(243)
Discontinued operations	(760)	(135)	(197)	-	-	(1,092)
Balance as at December 31, 2009	1,039	1,367	231	424	64	3,125
Balance as at January 1, 2010	1,039	1,367	231	424	64	3,125
Acquisitions or additions from independent development	**-**	**218**	**81**	**-**	**-**	**299**
Disposals (1)	**-**	**(309)**	**(160)**	**-**	**-**	**(469)**
Addition in respect of a business combination	**194**	**-**	**-**	**-**	**187**	**381**
Balance as at December 31, 2010	**1,233**	**1,276**	**152**	**424**	**251**	**3,336**
Amortization and impairment losses						
Balance at January 1, 2009	6	1,143	300	-	41	1,490
Amortization for the year	-	146	65	29	9	249
Depreciation for discontinued operations	-	5	12	-	-	17
Disposals (1)	-	(197)	(46)	-	-	(243)
Discontinued operations	-	(108)	(165)	-	-	(273)
Balance as at December 31, 2009	6	989	166	29	50	1,240
Balance as at January 1, 2010	**6**	**989**	**166**	**29**	**50**	**1,240**
Amortization for the year	**-**	**137**	**82**	**31**	**19**	**269**
Disposals (1)	**-**	**(309)**	**(160)**	**-**	**-**	**(469)**
Addition in respect of a business combination	**47**	**-**	**-**	**-**	**1**	**48**
Balance as at December 31, 2010	**53**	**817**	**88**	**60**	**70**	**1,088**
Carrying amount						
January 1, 2009	1,793	358	79	422	22	2,674
December 31, 2009	1,033	378	65	395	14	1,885
December 31, 2010	**1,180**	**459**	**64**	**364**	**181**	**2,248**

(1) Fully amortized intangible assets

(2) Depreciation commenced in January 2009, as the network was readied and the frequencies became available for use.

NOTE 11 – INTANGIBLE ASSETS (CONTD.)

Total value of goodwill attributable to each cash-generating unit:

	2010	2009
	NIS millions	**NIS millions**
Cellular communication – Pelephone Communications Ltd. (1)	**1,027**	1,027
Others	**153**	6
	1,180	1,033

(1) Goodwill impairment testing - Pelephone

The value of the use of cellular communications – Pelephone, was calculated using the discounted cash flow (DCF) method, based on the expected cash flow for the next five years. The expected cash flow is based on Pelephone’s results in 2010 and future growth and market shares are affected by the intensifying competition, regulation and new operators (MVNOs and a fourth cellular operator). In addition, it is assumed that migration to Pelephone’s new network will contribute to its marketing position, improve the customer mix and help to maintain stable ARPU (with adjustments for the lifting of interconnectivity) following the increase in revenue from roaming services and content/added value services.

The five-year revenue forecast is based on the forecast of the number of subscribers and average income, with reference to the effect of the entry of the MVNO and increased competition commencing from 2011 as well as reduction of interconnect prices commencing from this year. Pelephone is growing slowly in a market that is becoming saturated. An annual increase of 3% in revenue is assumed. The operating, sales and marketing expenses were adjusted for Pelephone's volume of operations. Tax is deducted from the profit at the statutory tax rates each year, plus 1%.

The investments were estimated according to the assumptions of an independent assessor regarding Pelephone’s investment plan, which includes investment in the LTE network (including acquisition of frequencies) in 2012-2013 (which have not yet been approved by the management of Pelephone), and ongoing investments.

The cost of capital used is 11%. In addition, it was assumed that the permanent growth of Pelephone will be 1%. Valuation of Pelephone was based on the comparative method, with a comparison of Partner and Cellcom which operate in the same legal and business environment. The comparison indicates that the value that was estimated using the DCF method is within the range of the reasonable value that was calculated using these multiples.

This valuation was made by an external appraiser.. Based on this valuation, the Group was not required to record an impairment of Pelephone’s cellular cash-generating unit.

NOTE 12 – DEFERRED AND OTHER EXPENSES

	December 31, 2010	December 31, 2009*	December 31, 2008*
	NIS millions	NIS millions	NIS millions
Long-term prepaid expenses in respect of use of capacities **	**288**	296	234
Other prepaid expenses	**4**	5	5
	292	301	239

* Retrospective application by restatement, see Note 2H

** See Note 3G

The amount of amortization recognized in the statement of income is NIS 26 million (in 2009, NIS 22 million; in 2008, NIS 20 million).

NOTE 13 - INVESTEES

A. Equity-accounted associates

(1) Below is a summary of main associates, without adjustment for ownership percentage held by the Group:

a. Financial position

	Ownership %	December 31 Current assets	Non-current assets	Total assets	Current liabilities	Non-current liabilities	Total liabilities	Equity (deficit)
		NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
2010*								
DBS Satellite Services (1998) Ltd.	**49.78%**	**180**	**1,063**	**1,243**	**802**	**3,863**	**4,665**	**(3,422)**
2009								
DBS Satellite Services (1998) Ltd.	49.78%	171	1,035	1,206	903	3,411	4,314	(3,108)
Walla! Communications Ltd.	34.24%	149	31	180	78	8	86	94

b. Operating Results

	Ownership (%)	Year ended December 31 Revenue	Gross profit	Operating profit (loss)	Profit (loss)
		NIS millions	NIS millions	NIS millions	NIS millions
2010 *					
DBS Satellite Services (1998) Ltd.	**49.78%**	**1,583**	**454**	**178**	**(314)**
2009					
DBS Satellite Services (1998) Ltd.	49.78%	1,530	488	248	(223)
Walla! Communications Ltd.	34.24%	132	73	28	20

* In 2010, Walla Communications Ltd. was consolidated. See Note 5A.

NOTE 13 – INVESTEES (CONTD.)

A. Equity-accounted associates (contd.)

(2) Additional details regarding associates held indirectly by the Company

As at December 31, 2010, the investment in an associate includes the Company's investments in shares, share options and loans to DBS. The loans are presented at fair value as at August 21, 2009 less the Company's share in the losses at that date. For details of deconsolidation of DBS in 2009, see section E below.
The Company's subsidiaries have negligible investments in other associates.

a. Details of the Company's loans to DBS, according to the terms of the loans:

	December 31	
	2010	2009
	NIS million	NIS million
CPI-linked loans	**1,145**	1,119
CPI-linked loans, bearing interest at a rate of 5.5%	**286**	265
CPI-linked loans, bearing interest at a rate of 11%	**1,112**	979
	2,543	2,363

b. Details of the carrying amount of the loans as stated in the financial statements*:

	December 31
	2010
	NIS millions
CPI-linked loans	**44**
CPI-linked loans, bearing interest at a rate of 5.5%	**172**
CPI-linked loans, bearing interest at a rate of 11%	**1,135**
	1,351

* The fair value at the deconsolidation date, including interest and linkage differences accumulated from the deconsolidation date through to December 31, 2010.

c. Activity in the investment account of DBS:

	2010
	NIS millions
Balance as at January 1, 2010	**1,184**
Interest and linkage differences	**159**
Company's share in capital reserves	**4**
Company's share in losses	**(263)**
Balance at December 31, 2010	**1,084**

NOTE 13 – INVESTEES (CONTD.)

A. Equity-accounted associates (contd.)

(2) Additional details regarding associates held indirectly by the Company

d. The Company's Board of Directors approved the waiver of NIS 250 million of the interest-free linked loans that the Company provided DBS, provided the other shareholder of DBS agree to waive NIS 252 million of the loan it provided to DBS.
The waiver is contingent on an arrangement between the Company and the Tax Authority and a waiver agreement signed by the Company with the other controlling shareholder before December 31, 2011. In addition, waiver of the debt requires the approval of the general meeting, which will be convened after the agreement has been signed.

e. DBS has a current debt to the Group companies. The balance of DBS's current debt to the Group companies amounts NIS 59 million, of which NIS 47 million is to the Company. See Note 30 below.

f. For details of DBS's financial position, see Notes 5 and 28 to the financial statements of DBS for 2010, which are attached to these financial statements. In addition, see Note 32 to the financial statements of DBS for subsequent events.

g. For loans provided by the shareholders to DBS, see Note 16 to the financial statements of DBS, which are attached to these financial statements.

h. For guarantees provided by the Company for DBS, see Note 20D and G.

i. Deconsolidation of DBS in 2009

On August 20, 2009, the Supreme Court accepted the appeal of the Antitrust Commissioner against the merger notice filed by the Company and DBS regarding exercise of options for DBS shares by the Company, and ruled against the merger. The ruling of the Supreme Court is a peremptory ruling. Until the ruling of the Supreme Court, the Company consolidated the financial statements of DBS in its financial statements (the Company held 49.8% of the share capital of DBS), even though it did not have legal control of DBS, as in view of all the circumstances, including the Company's additional potential voting rights by virtue of the options, in the opinion of the Company, it was able to direct the financial and operational policy of DBS.

The Company estimates that the ruling of the Supreme Court, which is final and irrevocable, constitutes an external legal barrier to the Company's ability to obtain more than 50% of the voting rights in DBS, will lead to a material change in the operations between the Company and YES and its shareholders, following which the Company will no longer be able to direct the financial and operational policy of DBS. Therefore, the Company cannot be regarded as controlling DBS (neither legally nor effectively). Accordingly, as from August 21, 2009, the Company no longer consolidates the reports of DBS in its financial statements and the investment in DBS shares is stated according to the equity method commencing from that date.

At the deconsolidation date, the Company presented its investment in shares, share options and loans to DBS according to the equity method based on a valuation by an independent assessor. This included valuation of the fair value of DBS's tangible assets, intangible assets (except for goodwill) and liabilities. The difference between the fair value of the remaining investment in DBS at the deconsolidation date and the Company's share in the identifiable assets and liabilities of DBS at that date constitute the goodwill included in the calculation of the Company's investment in DBS at the deconsolidation date.

At the deconsolidation date and as at December 31, 2010 and December 31, 2009, goodwill that was included as part of the investment amounts to NIS 814 million.

NOTE 13 – INVESTEES (CONTD.)

A. Equity-accounted associates (contd.)

(2) Additional details regarding associates held indirectly by the Company

i. Deconsolidation of DBS in 2009 (contd.)

The Company stated the investment at NIS 1.175 billion and recognized a profit of NIS 1.538 billion under profit from discontinued operations.

The consolidated statements of income for the years ended December 31, 2010, 2009 and 2008 are stated without consolidation of the statements of DBS. The operational results of DBS for the period up to August 20, 2009 were presented as discontinued operations.

Results of discontinued operations as stated in the financial statements of 2009

	From January 1 to August 20 2009	Year ended December 31 2008
	NIS millions	NIS millions
Revenue	970	1,513
Cost of revenue	663	1,091
Gross profit	307	422
Selling and marketing expenses	79	128
General and administrative expenses	74	117
	153	245
Operating profit	154	177
Finance expenses, net	313	441
Loss before income tax	(159)	(264)
Income tax	-	1
Loss after income tax	(159)	(265)
Profit from deconsolidation of a subsidiary	1,538	-
Profit (loss) for the period from discontinued operations	1,379	(265)

Cash flow from discontinued operations as stated in the financial statements of 2009

	From January 1 to August 20 2009	Year ended December 31 2008
	NIS millions	NIS millions
Cash flow from operating activities	260	347
Cash flow used for investment activities	(176)	(237)
Cash flow arising from (used for) finance activities	(84)	(110)
Cash flow from discontinued operations	-	-

NOTE 13 – INVESTEES (CONTD.)

B. Subsidiaries held directly by the Company

(1) General

	Country of incorporation	Company's rights in capital	Amounts provided by the Company to subsidiaries: Loans NIS millions	Amounts provided by the Company to subsidiaries: Guarantees NIS millions	investment in consolidated subsIdiaries NIS millions
2010					
Pelephone Communications Ltd.	Israel	100%	**-**	**-**	**3,983**
Bezeq International Ltd.	Israel	100%	**-**	**70**	**743**
Bezeq Online Ltd.	Israel	100%	**5**	**-**	**30**
Bezeq Zahav (Holdings) Ltd.	Israel	100%	**1,029**	**-**	**1,049**
Walla! Communications Ltd. *	Israel	71.55%	**-**	**-**	**188**
Stage One Venture Capital Fund	Israel	71.8%	**-**	**-**	**40**
			1,034	**70**	**6,033**
2009					
Pelephone Communications Ltd.	Israel	100%	-	-	3,570
Bezeq International Ltd.	Israel	100%	-	70	710
Bezeq Online Ltd.	Israel	100%	10	-	25
Bezeq Zahav (Holdings) Ltd.	Israel	100%	1,006	-	1,033
Stage One Venture Capital Fund	Israel	71.8%	-	-	43
			1,016	70	5,381

* Walla has investments in other subsidiaries that are not material.

(2) Dividend received or receivable from subsidiaries

	Year ended December 31 2010 NIS million	Year ended December 31 2009 NIS million
From Pelephone Communications Ltd.	**625**	425
From Bezeq International Ltd.	**216**	210
From Stage One Venture Capital Fund	**10**	8
	851	643

(3) Details of Group entities

a. Pelephone Communications Ltd.

Pelephone Communications Ltd. ("Pelephone") is a wholly-owned subsidiary of the Company. Pelephone provides cellular communication services and value added services and markets and repairs terminal equipment.

Pelephone operates under an operating license from the Ministry of Communications – a general license for cellular services ("the License"). The License was received on February 7, 1996. After Pelephone won an additional band of frequencies in December 2001, the term of the license was extended to 2022, with an option for extension, subject to the terms of the license, for an additional six years ("the additional period") and for renewal for one or more additional periods of six years after the additional period.

NOTE 13 – INVESTEES (CONTD.)

B. Subsidiaries held directly by the Company (contd.)

(3) Details of Group entities (contd.)

b. Bezeq International Ltd.

Bezeq International Ltd. ("Bezeq International") is a wholly-owned subsidiary of the Company. Bezeq International was incorporated on April 5, 1995 to engage in international communications. Since 1999, Bezeq International has also been providing internet access services. Following the merger with BezeqCall Communications Ltd. (BezeqCall), BezeqCall's network end point (NEP) license was assigned to Bezeq International.

On February 8, 2009, the Minister of Communications granted an operation license for domestic telecommunication services to BIP Communication Solutions Limited Partnership ("BIP"), a corporation owned by Bezeq International. The license is for the supply of domestic broadband telephony services (VoB) to private customers through BIP. On August 2, 2009, Bezeq International started to supply domestic broadband telephony services (VoB) to its private customers through BIP. On December 30, 2009, after the Ministry of Communications determined that Bezeq's market share in domestic telephony in the business sector fell below 85%, the license was amended to permit Bezeq International to supply the services to its corporate customers as well.

In August 2010, the Company started to sell service bundles, including Bezeq International's internet services, following the amendment to the international operator license.

Subsequent to the reporting date, in March 2011, the Company's Board of Directors approved the establishment by Bezeq International of a subsidiary in Italy, at an establishment cost of up to EUR 25,000 and a subsidiary in the USA, at an establishment cost of up to USD 150,000.

c. Bezeq Online Ltd.

Bezeq Online Ltd. ("Bezeq Online") is a wholly-owned subsidiary of the Company. Bezeq Online was established in December 2000 and commenced operations in 2001, providing call center outsourcing services.

d. Bezeq Zahav (Holdings) Ltd.

Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav") is wholly-owned and controlled by the Company. Bezeq Zahav was established in September 1995 Bezeq Zahav holds debentures issued by the Company.

e. Walla! Communications Ltd.

Walla! Communications Ltd. ("Walla") is controlled by the Company and the Company holds 71.55% of Walla shares. Walla is a public company and its shares are traded on the Tel Aviv Stock Exchange. The market value of the Walla shares held by the Company as at December 31, 2010 is NIS 164 million. Walla provides internet, management and media services for a range of populations.

f. Stage One Venture Capital Fund (Israel) L.P.

THIS IS A VENTURE CAPITAL FUND IN WHICH THE MANAGEMENT RIGHTS ARE HELD BY THE SOCI (STAGE ONE CAPITAL INVESTMENT)- , AND THE COMPANY HAS RIGHTS IN THE PROFITS. NOTE 14 – DEBENTURES, LOANS AND BORROWINGS, INCLUDING OBLIGATIONS TO BANKS

A. Composition:

	December 31, 2010	December 31, 2009
	NIS million	NIS million

Notes to the Financial Statements as at December 31, 2010

Current liabilities		
Short-term credit	**7**	-
Current maturities of debentures	**895**	798
Current maturities of bank loans	**47**	64
	949	862
Non-current liabilities		
Debentures	**1,967**	2,716
Bank loans	**2,801**	558
	4,768	3,274
	5,717	4,136

NOTE 14 – DEBENTURES, LOANS AND BORROWINGS, INCLUDING OBLIGATIONS TO BANKS (CONTD.)

B. Terms and debt repayment schedule

				December 31, 2010		December 31, 2009	
	Currency	Nominal interest rate %	Redemption year	Par value NIS millions	Carrying amount NIS millions	Par value	Carrying amount Currency
Short-term credit	NIS	3.15	2011	**7**	**7**	-	-
Loans from banks and others:							
Linked to the CPI	NIS	5.2– 4.45	2012-2015	**153**	**178**	194	222
Unlinked (1)							
Variable interest	NIS	Prime + -0.33 Up to prime + 0.2	2011-2019	**1,370**	**1,370**	400	400
Fixed interest	NIS	5-5.6	2011-2017	**1,300**	**1,300**	-	-
					2,855		622
Debentures issued to the public:							
Linked to the CPI (2)	NIS	4.8-5.3	2011-2016	**1,807**	**2,163**	2,107	2,476
Debentures issued to institutions and others:							
Linked to the CPI (3)	NIS	4.4-5.95	2014-2015	**593**	**699**	898	1,038
Total interest-bearing liabilities					**5,717**		4,136

NOTE 14 – DEBENTURES, LOANS AND BORROWINGS, INCLUDING OBLIGATIONS TO BANKS (CONTD.)

B. Terms and debt repayment schedule (contd.)

(1) In 2010, the Company completed debt financing amounting to NIS 2.6 billion, through loans from banks in Israel. Of this amount, NIS 400 million is against early repayment of bank loans from March 2009. Loans in the amount of NIS 1.3 billion are at fixed interest and the balance of NIS 1.3 billion are at variable interest, which are payable as follows:

A. Loans in the amount of NIS 1.1 billion, which are unlinked to the CPI and bear variable interest of prime minus 0.21%, are repayable in four equal annual payments of the principal between 2013 and 2016. The interest on the loans is payable twice a year.

B. A loan in the amount of NIS 200 million, which is unlinked to the CPI and bears variable interest of prime minus 0.33%, is repayable in six equal annual payments of the principal between 2012 and 2017.

C. Loans in the amount of NIS 800 million, which are unlinked to the CPI and bear average fixed interest of 5.56%, are repayable in four equal annual payments of the principal between 2013 and 2016. The interest on the loans is payable twice a year.

D. Loans in the amount of NIS 500 million, which are unlinked and bear average fixed interest of 5%, are repayable in four equal annual payments of the principal between 2012 and 2017.

(2) The par value of the Company's debentures is NIS 2,686,967,000, of which NIS 1,806,867,000 par value was issued to the public as follows:

A. The par value of debentures (Series 4) is 300,000,000 of NIS 1 par value each, repayable in 2011. The annual interest rate for these debentures is 4.8%.

B. The par value of debentures (Series 5) is 2,386,967,000 of NIS 1 par value each, of which 1,506,867,000 debentures were issued to the public and to institutional investors (partially through Bezeq Zahav) and the balance of 880,100,000 were issued to Bezeq Zahav. The debentures are repayable in six equal annual payments in each of the years 2011 to 2016. The annual interest rate for these debentures is 5.3%.

(3) Pelephone issued three series of debentures in a private placement to institutional investors. The debentures, which were issued at par value, are linked to the CPI, bear annual interest of 4.4% - 5.2%, and are repayable in equal semi-annual payments up to 2015. The interest is paid on the unpaid balance of the principal. The balance of the debentures at December 31, 2010, is NIS 597 million.

NOTE 14 – DEBENTURES, LOANS AND BORROWINGS, INCLUDING OBLIGATIONS TO BANKS (CONTD.)

C. Liens, securities and financial covenants

(1) The private debentures of the Company, whose carrying amount at December 31, 2010 is NIS 102 million, are secured by a token charge (whereby an insignificant amount is secured). In addition, the Company created a negative pledge in favor of the debenture holders and in favor of a bank, which includes exceptions, inter alia, for the matter of a lien on assets that are purchased or expanded by the Company, if the undertakings for which the charge serves as security is created for the purchase or expansion of those assets and for the matter of a token charge.

The lenders have a right to call for immediate payment of the debentures in cases where the Company does not repay the debentures or breaches their terms, if a significant attachment is imposed on its assets, if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to run its business, or if the holder of another charge realizes the charge it has on the assets of the Company.

In addition, some of the lenders, with a debenture balance of NIS 77 million as at December 31, 2010, may call for immediate payment of the debentures after the State's holdings in the Company's equity fall below 26% (a condition which has existed since October 11, 2005). For this reason, the balance in the financial statements is stated under short-term liabilities.
In the Company's opinion, at the reporting date, it is in compliance with all the aforementioned terms, except for the term of the decrease of the State's holdings in the Company.

(2) The Company raised a negative pledge in favor of the creditors for a bank debt of NIS 2.6 billion, as set out in section B(1) above.

(3) a. At December 31, 2010, the bank loans and debentures of Pelephone have a carrying amount of NIS 775 million and are secured by an irrevocable undertaking by Pelephone to the credit providers not to encumber its assets without their consent (a negative pledge).

The undertaking includes:

(1) A declaration that Pelephone will not encumber its assets (as may be from time to time), in whole or in part, in any manner including by means of a floating lien or a fixed lien of any type or rank, in favor of any third party, without the prior written consent of the credit providers.

(2) Compliance with the following financial covenants:

a. An undertaking that Pelephone's debt will not exceed three times its equity and an undertaking that as long as that ratio exceeds 2.5, dividends will not be distributed and management fees will not be paid to the shareholders.

b. Pelephone undertook that the amount of its debts will not exceed NIS 3.8 billion (linked to the CPI known in January 2002).

c. An undertaking towards a certain bank that its total debt to it will not exceed 40% of its total debts to all the financial entities.

As of the date of the financial statements, Pelephone is in compliance with the financial covenants and with its undertakings to the banks and the debenture holders. Non-compliance with these undertakings would allow the banks and the debenture holders to call for immediate repayment of the loans it received from the banks and the debentures.

NOTE 14 – DEBENTURES, LOANS AND BORROWINGS, INCLUDING OBLIGATIONS TO BANKS (CONTD.)

C. Liens, securities and financial covenants

(3) (contd.)

b. Under its general license for cellular services, Pelephone is not permitted to sell, lease or pledge any of its assets used for the implementation of the license, without the consent of the Minister of Communications, except for:

(1) A pledge on one of the license assets in favor of a bank operating lawfully in Israel, for receipt of bank credit, provided that it submitted notice to the Ministry of Communications regarding the pledge it intends to register, noting that the pledge agreement includes a clause ensuring that in any case, exercise of the rights by the bank will not impair in any way the provision of the services pursuant to the license.

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

(4) According to the agreement between Walla and its subsidiary for a loan to Walla, amounting to NIS 70 million at December 31, 2010, Walla undertook to meet financial covenants according to its consolidated financial statements, as set out below:

a. Walla's equity will not fall below NIS 70 million at any time.
b. The ratio between Walla's equity and the statement of financial position will not fall below 25% at any time.
c. The ratio between Walla's available cash and the current maturities will not fall below 1.2.
d. The ratio between the financial debt and Walla's available cash will not exceed 4.

At December 31, 2010, Walla is in compliance with these financial covenants.

NOTE 15 - TRADE AND OTHER PAYABLES

	December 31, 2010	December 31, 2009
	NIS million	NIS million
Trade payables (open accounts)	**1,061**	1,091
Trade payables consisting of related and interested parties	**46**	8
Other payables		
Liabilities to employees and other liabilities for salaries	**348**	297
Institutions	**183**	200
Expenses due	**112**	85
Accrued interest	**93**	99
Derivatives	**10**	2
Other payables	**24**	14
Total other payables	**770**	697

Amounts payable denominated in a currency other than the functional currency include NIS 174 million for trade payables denominated in US dollars (in 2009, NIS 258 million).

NOTE 16 - PROVISIONS

	Employee claims	Customer claims	Supplier and communication provider claims	Punitive claims	Enterprise and company claims	State and Authorities claims	Dismantling and clearing of sites	Liability, onerous contracts and others	Total
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Balance as at January 1, 2010	139	45	11	1	7	159	60	29	451
Provisions created in the period	**2**	**11**	**1**	**1**	**3**	**16**	**8**	**5**	**47**
Provisions used in the period	**(1)**	**-**	**-**	**-**	**-**	**(78)**	**-**	**(2)**	**(81)**
Provisions cancelled in the period	**(44)**	**-**	**(7)**	**-**	**-**	**(32)**	**(4)**	**(10)**	**(97)**
Balance as at December 31, 2010	**96**	**56**	**5**	**2**	**10**	**65**	**64**	**22**	**320**
Current	**96**	**56**	**5**	**2**	**10**	**65**	**-**	**17**	**251**
Non-current	**-**	**-**	**-**	**-**	**-**	**-**	**64**	**5**	**69**

Claims
For details of legal claims, see Note 18.

Dismantling and clearing of sites
The provision is in respect of Pelephone's obligation to clear the sites that it leases.

NOTE 17 – EMPLOYEE BENEFITS

Employee benefits include post-employment benefits, other long-term benefits, termination benefits, short-term benefits and share-based payments. For details of share-based payments, see Note 27 below.

A. Defined contribution plans

(1) The pension rights of Company employees for the period of their employment in the civil service through January 31, 1985, are covered by a pension fund ("the Makefet Fund"), which assumed the State's obligation following an agreement between the Government of Israel, the Company, the Histadrut and the Makefet Fund.

(2) Liabilities for employee benefits at retirement age in respect of the period of their service in the Company and its subsidiaries are covered in full by regular payments to pension funds and insurance companies.

(3) The severance obligation to employees who leave their employment on terms entitling them to compensation is covered, for the period from February 1, 1985, by regular contributions to such pension funds and insurance companies (in accordance with Section 14 of the Severance Pay Law). Severance pay for the period of employment in the civil service through January 31, 1985, is paid by the Company, and the monies accumulated in the Makefet Fund for that period are kept in a fund that will be used for the employees' rights. For some of the employees, the Company has an obligation to pay severance in excess of the amount accumulated in the compensation fund which is in the employees' names. See section B(1) below.

B. Defined benefit plans

(1) The severance obligation included in the statement of financial position represents the balance of the obligation not covered by contributions and/or insurance policies in accordance with the existing labor agreements, the Severance Pay Law, and the salary components which the managements of the companies believe entitle the employees to receive compensation. For this part of the obligation, there are deposits in the name of Group companies in a recognized compensation fund. The reserves in compensation funds include accrued linkage differentials and interest deposited in compensation funds, in banks and in insurance companies. Withdrawal of the reserve monies is contingent upon fulfillment of the provisions in the Severance Pay Law.

(2) The collective agreement of December 2006 (see section D below), provides, among others, that employees who transferred from the civil service to the Company and are due to end their employment due to retirement after December 31, 2016, are entitled to a supplement to close the gap between the Civil Service Law and the regulations governing the Makefet Fund. The financial statements of the Company include the obligation for this benefit.

(3) According to some of the personal employment agreements, a number of senior employees are entitled to early retirement terms (pension and retirement grants) which are not dependent on the existing retirement agreements for all employees. Accordingly, a liability is included in the financial statements.

(4) Benefits for notice are paid upon severance. Accordingly, a liability is included in the financial statements in accordance with an employment agreement and an actuarial calculation.

(5) Company retirees receive, in addition to the pension payments, benefits which consist mainly of a holiday gift (linked to the dollar exchange rate), financing the upkeep of retiree clubs, and social activities. The Company's liability for these costs accumulates during the employment period. The Company’s financial statements include the expected costs in the post- employment period, based on an actuarial calculation.

NOTE 17 – EMPLOYEE BENEFITS (CONTD.)

C. Other long-term employee benefits

The financial statements include a provision in respect of redemption and use of sick leave. The right to accumulate sick leave was taken into account for all employees in the Group. Only employees eligible under the terms of the employment agreement may redeem sick leave. The provision was computed on the basis of an actuarial calculation, including the assumption of positive accumulation of days by most of the employees and use of days by the last in first out (LIFO) method.

D. Benefits for early retirement and dismissal

The Company has a number of collective agreements that include terms for early retirement. Below are details of the most recent agreement that was signed in December 2006 and an amendment to the agreement signed in December 2010:

(1) The collective agreement of December 2006, between the Company and the union and the New Histadrut, regulates the labor relations in the Company following the transfer of control in the Company from the State of Israel, and delineates a new organizational structure for the Company. The amendment to the agreement of December 2010 regulates the labor relations in the Company following transfer of control in the Company from Ap.Sb.Ar. Holdings Ltd. (“Ap.Sb.Ar.”) to B Communications Ltd. (“B Communications”). The agreement stipulates, inter alia, that all the agreements, arrangements and procedures existing in the Company prior to signing the agreement will continue to apply only to the permanent long-standing employees in the Company.

(2) The Company may, at its discretion, terminate the employment of 245 permanent employees in one or more of the years 2010-2016. The retirement terms that will be offered to the retirees will be largely the same as the retirement terms prevailing in the Company up to that date. The term of the agreement (after the amendment made in 2010) is from the date the agreement is signed through December 31, 2015. The Company has an option to extend it for another two years, through December 31, 2017. The term of the retirement section in the agreement will be through December 31, 2016.

On January 24, 2011, the Board of Directors of the Company approved a plan for early retirement of 260 employees at a cost of no more than NIS 281.5 million. This expense will be recognized in the Company’s financial statements for the first quarter of 2011.

NOTE 17 – EMPLOYEE BENEFITS (CONTD.)

E. Liabilities for employee benefits

	December 31, 2010	December 31, 2009
	NIS million	NIS million
Unfunded obligations (1)	**225**	250
Funded obligations (2)	**213**	203
Total present value of obligations	**438**	453
Fair value of plan assets	**(152)**	(148)
Obligation for defined benefit plans (post-employment plans)	**286**	305
Obligation for a special bonus	**26**	-
Obligation for holiday pay	**89**	89
Obligation for sick leave	**126**	122
Obligation for voluntary early retirement	**47**	283
Total employee benefits	**574**	799
Stated in the statement of financial position as:		
Short term	**269**	505
Long term	**305**	294
	574	799

(1) Unfunded obligations are those obligations for which the Company did not fund a reserve to finance its liabilities and they include a provision for notice, an obligation to the Company's pensioners, an obligation for early retirement of senior employees in the Company and an obligation for employees transferred from the civil service.

(2) Obligations for which the Group companies funded a reserve to finance its obligations (severance obligation)

NOTE 17 – EMPLOYEE BENEFITS (CONTD.)

F. Defined benefit plans (post-employment plans)

	2010	2009
	NIS millions	NIS millions
1. Change in obligation in respect of defined benefit plans		
Obligation in respect of a defined benefit plan as at January 1	**453**	429
Benefits paid according to the plans	**(32)**	(40)
Costs of current service, interest and exchange rate differences (see section 3 below)	**34**	65
Retirement and curtailment of benefits	**(9)**	(17)
Actuarial losses (gains) charged to equity (see section 5 below)	**(17)**	24
Additions in respect of a business combination	**9**	-
Derecognition of discontinued operations	**-**	(8)
Defined benefit obligation as at December 31	**438**	453
2. Change in plan assets and cost of past service		
Fair value as at January 1	**148**	140
Deposits	**10**	11
Withdrawals	**(9)**	(5)
Expected proceeds from plan assets (see section 3 below)	**5**	6
Gains (losses) charged to equity (see section 5 below)	**(2)**	11
Amortization of past service cost, see section 3 below	**(7)**	(12)
Additions in respect of a business combination	**7**	-
Derecognition of discontinued operations	**-**	(3)
Fair value as at December 31	**152**	148

NOTE 17 – EMPLOYEE BENEFITS (CONTD.)

F. Defined benefit plans (post-employment plans) (contd.)

	2010	2009	2008
	NIS millions	NIS millions	NIS millions
3. Expense recognized in the statement of income			
Cost of current service	**14**	37	42
Interest on the obligation	**24**	29	24
Other	**(11)**	(12)	(1)
	27	54	65
The expense is included in the following items in the statement of income:			
Salary expenses	**12**	31	45
Financing expenses	**15**	23	20
	27	54	65
4. Actual return on plan assets	**3**	15	(7)
5. Actuarial losses (gains) recognized directly in **other comprehensive income (before tax)**			
Amount accrued as at January 1	**13**	-	(2)
Amount recognized in the period	**(15)**	13	2
Amount accrued as at December 31	**(2)**	13	-

6. Historical information

	December 31				
	2010	2009	2008	2007	2006
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Adjustments for liabilities arising from past experience	**(17)**	**(13)**	**(21)**	**(15)**	**4**
Adjustments for assets arising from past experience	**(1)**	**20**	**13**	**(1)**	**(4)**

In 2011, the Group expects to pay NIS 18 million as a contribution to a defined benefit plan.

NOTE 17 – EMPLOYEE BENEFITS (CONTD.)

G. Actuarial assumptions

Principal actuarial assumptions for defined benefit plans and for other long-term benefit obligations at the reporting date:

(1) Mortality rates are based on the rates published in Insurance Circulars 6-3-2007 of the Ministry of Finance, except for early retirement, which was calculated according to the agreement with the insurance company, including future changes in the mortality rate.

(2) Churn rates were determined on the basis of the past experience of the Company and the subsidiaries, distinguishing between different employee populations and taking into account the number of years of employment.
The main assumptions regarding the churn rate were determined with a distinction made between permanent employees (between 3.5% in the first year to 0.5% over 10 years), personal contract employees (5.5% per year), senior employees (20% per year), and temporary employees (between 34% in the first year and 25% for more than 7 years).

(3) The real discounted rate is based on yield on government bonds at a fixed interest rate with a life equal to that of the gross liability.

	December 31, 2010	December 31, 2009	December 31, 2008
	Average capitalization rate	Average capitalization rate	Average capitalization rate
	%	%	%
Sick leave	1.9	1.8	3.4
Compensation	2	1.4	3.3
Retirement benefit – holiday gift *	4.3	4.9	4.4
Retirement benefit – clubs and activities	2.9	2.7	3.6
Early notice to senior employees	1.5	1.4	3.1

* At a discount rate based on US corporate debentures.

(4) Assumptions regarding salary increases were made on the basis of experience and management's assessments, distinguishing between groups of employees The main assumptions (in real terms) regarding salary increases are as follows:
For permanent employees, the average salary increment is 3% for young employees, with a linear decrease to 1.5% per year up to age 60. For employees in a monthly collective agreement, the average salary increment is of 3% per year. For employees in a personal collective hourly employment agreement, the average salary increment is 7% per year. For employees in a personal employment agreement, the average salary increment is between 4% and 0.5%, depending on the age of the employee, and for senior employees, the average salary increment is 6% per year.

(5) The forecasted growth rate of the assets accumulated in all Group companies is 2% in real terms for old pension funds in the administration and 5.57% in real terms for old pension funds that are not part of the arrangement. For new, subsidized pension funds, a guarantee of 4.86% is assumed for 30% of the assets. For officers' insurance where the severance interest is not transferred to compensation and their start date is prior to 1989, guaranteed interest is 4.25% in real terms. The growth rate in other plans is the discount interest.

(6) An obligation for voluntary early retirement includes an obligation for pension and grants. The obligation for pension is calculated according to the terms of the agreement of December 2006 (see section D above) and in accordance with the agreement with the insurance company. The obligation is affected by changes in the interest rates of debentures until the purchase of the policy and payment to the insurance company.

NOTE 17 – EMPLOYEE BENEFITS (CONTD.)

H. Other

According to the collective agreements applicable to labor relations in the Company, and in accordance with agreements with the Makefet Fund, an option is reserved for Company employees who are transferred employees, to retire under one of two retirement tracks. The method for calculating the cost of early retirement for the transferred employees was laid down in the provisions of a number of agreements and documents drawn up between the Company and the Makefet Fund between 1990 and 1996. The Company contends that the Makefet Fund violated the provisions of the agreements, and therefore, in 2003, the Company filed a claim against the Makefet Fund at the district labor court in Tel Aviv, in the amount of NIS 280 million. The Makefet Fund filed defense documents, in which it rejects the allegations of the Company and contends that it acted in accordance with the agreements between it and the Company. The case is in the evidentiary stage.

NOTE 18 – CONTINGENT LIABILITIES

During the normal course of business, legal claims were filed against Group companies or there are pending claims (“hereinafter in this section: “legal claims”).

In the opinion of the managements of the Group companies, which are based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements (Note 16 above) include appropriate provisions, where provisions are required to cover the exposure resulting from such claims.
In the opinion of the managements of the Group companies, the additional exposure as at December 31, 2010, due to claims filed against the Group companies on various matters and which are not more likely than not to be realized, amounts to NIS 15.7 billion (of which an amount of NIS 1.96 billion is for claims, which at this stage, cannot be assessed, as set out in sections B and E below). This amount has not been provided for. This amount and all the amounts of the additional exposures in this note are linked to the CPI and are stated net of interest. For updates subsequent to the reporting date, see section B below.
For motions for certification of class action suits to which the Group has exposure beyond the aforesaid (since the claims do not state an exact amount), see sections B and D below.

Following is a detailed description of the Group's contingent liabilities at December 31, 2010, classified into groups with similar characteristics.

A. Employee claims

During the normal course of business, employees and former employees filed collective and individual claims against the Company. These are mainly claims concerning recognition of various salary components as pension components, recognition of various components in the determining salary for severance pay and pension rights. In addition, employees and former employees also filed various individual claims against the other Group companies. At December 31, 2010, the additional exposure (beyond the provisions included in these financial statements) for these claims amounts to NIS 2 billion and relates mainly to claims filed by groups of employees or individual claims with wide ramifications. In the opinion of the managements of the Group companies, based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 96 million, where provisions are required to cover the exposure resulting from such claims.

NOTE 18 – CONTINGENT LIABILITIES

B. Customer claims

During the normal course of business, customers of the Group companies filed claims against the Group companies. These are mainly motions for certification of class actions concerning contentions of unlawful collection of payment and impairment of the service provided by the Group companies. At December 31, 2010, the amount of the additional exposure for customer claims amounts to NIS 7.1 billion (beyond the provisions included in these financial statements). Of these claims, there are claims amounting to NIS 1.92 billion, which, at this stage, cannot yet be estimated. There are other claims for which the Group has additional exposure beyond the aforesaid, which cannot be quantified, as the exact amount of the claims is not stated in the claim. In the opinion of the managements of the Group companies, based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 56 million, where provisions are required to cover the exposure resulting from such claims.

In addition, subsequent to the reporting date, customers of Group companies filed a number of claims, amounting to NIS 818 million, the exposure of which cannot be assessed at this stage, and customer claims of NIS 103 million were eliminated.

In the second quarter of 2008, four claims were filed against Bezeq International in the Tel Aviv and Central District Courts, concerning the use of international calling cards for destinations in the Philippines, Thailand and Nepal, together with motions for certification of class actions. The plaintiffs have applied for their claims to be certified as class actions on behalf of groups that include every person who, during the seven years prior to filing the claim and during the claim's proceeding, purchased phone cards of the type referred to in the claims. The plaintiffs estimate the loss sustained by all the members of the group at NIS 1.1 billion. In the opinion of the management of Bezeq International, based, inter alia, on the opinion of its legal counsel, the maximum amount of the exposure (included in the abovementioned exposure), for all these claims is negligible compared to the amount of the claim.

C. Supplier and communication provider claims

During the normal course of business, suppliers of goods and/or services and communications providers that the Group companies supply goods and/or services to or receive goods and/or services from filed various claims against the Group companies. These claims are usually for compensation for alleged damage as a result of the supply of the service and/or the product. On December 31, 2010, the amount of the additional exposure (beyond the provisions included in these financial statements) for these claims amounts to NIS 979 million. In the opinion of the managements of the Group companies, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions amounting to NIS 5 million, where provisions are required to cover the exposure arising from such claims.

D. Claims for punitive damages

During the normal course of business, claims were filed against Group companies for alleged physical damage or damage to property caused by Group companies (including in relation to environmental quality and radiation). At December 31, 2010, the amount of the additional exposure (beyond the provisions included in these financial statements) for punitive damages amounts to NIS 5 billion. This amount does not include claims for which the insurance coverage is not disputed. In addition, there are other claims for which the Group has additional exposure beyond the aforesaid, which cannot be quantified, as the exact amount of the claim is not stated in the claim.

In the opinion of the managements of the Group companies, based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 1.6 million, where provisions are required to cover the exposure resulting from such claims.

NOTE 18 – CONTINGENT LIABILITIES

E. Claims by developers and companies

During the normal course of business, claims were filed against some of the Group companies or officers, claiming liability and/or negligence of the Group companies and/or their directors in respect of their activities and/or the investments made in various projects. On December 31, 2010, the additional exposure (beyond the provisions included in these financial statements) for these claims amounts to NIS 320 million. In the opinion of the managements of the Group companies, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions amounting to NIS 10 million, where provisions are required to cover the exposure arising from such claims.

F. Claims by the State and authorities

During the normal course of business, various claims are pending against the Group companies by the State of Israel, government institutions and authorities (“the authorities”). These are mainly procedures related to regulations relevant to the Group companies and financial disputes concerning monies paid by the Group companies to the authorities (including property taxes) or by the authorities to the Group companies. At December 31, 2010, the additional exposure (in addition to the provisions included in these financial statements) for these claims amounted to NIS 275 million. Of these claims, there are claims amounting to NIS 32 million, which, at this stage, cannot yet be estimated. In the opinion of the managements of the Group companies, based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 65 million, where provisions are required to cover the exposure resulting from such claims.

In December 2000, the government filed a claim against Pelephone for royalties allegedly due from January 1994 to February 1996. The amount in the claim is NIS 260 million at the date of the claim, including principal, linkage differences and interest. In September 2010, the court ruled against Pelephone, accepting some of the government’s claims. Pelephone was required to pay the government NIS 150 million, including principal, linkage differences and interest. This amount was paid in October 2010. Additionally, in October 2010 Pelephone filed an appeal against the ruling at the Supreme Court. Prior to the ruling, the Group included a provision for the claim in its financial statements, amounting to NIS 76 million.

For claims against DBS, see Note 21 and Note 32E to the annual financial statements of DBS for 2010, which are attached to these financial statements.

NOTE 19 – AGREEMENTS

A. The Group companies have rental agreements. Contractual rental payments during the next five years, calculated according to the rent in effect at December 31, 2010, are as follows:

Year ended December 31	**NIS millions**
2011	**168**
2012	**165**
2013	**129**
2014	**85**
2015 onwards	**132**
	679

B. The Group has a number of operating lease agreements for periods of up to three years in respect of vehicles it uses. The contractual annual lease payments, calculated according to the payments in effect at December 31, 2010, are NIS 102 million

C. Most of the Group companies are required to pay royalties to the State of Israel. The rate of royalties paid was 1% in 2010, 1.5% in 2009 and 2% in 2008.

In January 2010, an amendment to the Communications Regulations (Telecommunications and Broadcasts) (Royalties), 5761-2001 was issued. The regulations include clarification of the royalties that a licensee owes the State. The amendment includes an exemption for the payment of royalties for revenue from high-speed communication services which commenced on January 1, 2004. As a result of this exemption, royalties expenses in 2009 decreased by NIS 32 million.
In January 2011, an amendment to the Communications Regulations (Royalties) was issued. According to the amendment, the rate of royalties will increase to 1.75% in 2011 and to 2.5% in 2012. The adjusted rate for calculation of royalties is effective from January 19, 2011.

D. Pelephone leases some of the sites from the Israel Lands Administration ("ILA"). Pelephone has an agreement with the ILA for use of the land to establish and operate communication sites. The agreement regulates payments to which the ILA is entitled for the period through December 31, 2008.
According to the agreement, at the end of the agreement period, and in the event of its annulment due to reasons set out in the agreement, Pelephone will evacuate the land. There is a similar agreement with the other cellular operators.
The agreement was extended to December 31, 2009 and was extended again until December 31, 2010.
At the reporting date, Pelephone and the other cellular operators are in advanced stages of negotiations to extend the agreement, however the agreement has not yet been renewed.
If, for any reason, the agreement is not renewed or extended, this could have a material negative effect on Pelephone, inter alia because Pelephone will be restricted in establishing sites on ILA land and it may also be required to vacate existing sites.

E. Pelephone uses Ericsson UMTS/HSPA infrastructure equipment and Nortel and Motorola CDMA infrastructure equipment. Pelephone has multi-annual agreements for maintenance, support and upgrade of software for the UMTS/HSPA network and a maintenance agreement for the Nortel network with Ericsson. Pelephone believes that it could be dependent on Ericsson for network support.

F. Pelephone has obligations to acquire terminal equipment amounting to NIS 455 million (at December 31, 2009, NIS 606 million).

G. In November 2010, Bezeq International signed an agreement with Alcatel-Lucent Submarine Networks to roll out a high speed submarine cable linking Israel to Italy. At the same time, Bezeq International acquired an indefeasible right of use of terrestrial infrastructure linking the cable in Italy to points of presence in western Europe.

H. For agreements for the purchase of property, plant and equipment, see Note 10J above.

NOTE 20 – SECURITIES, LIENS AND GUARANTEES

A. In May 2003, the Company provided, at the request of the Ministry of Communications, a bank guarantee of USD 10 million in connection with its general license for implementing telecommunications operations and for providing telecommunication services.

B. The Company provided a guarantee in favor of banks in connection with credit of up to NIS 70 million granted to a subsidiary.

C. The Company has received a demand for the forfeiture of a guarantee in the amount of approximately USD 6 million related to a project (HBTL) in a basic telephony tender in 1995 in India, in which the Company participated together with others. An appeal against an order given at the request of the developer, which prevents forfeiture of the guarantees, is being heard in the appeals department of the High Court in Delhi. The Company has applied to the court in India for release of the bank guarantees it provided. The court has yet to hear the application.

D. The Company provided a guarantee of NIS 10 million for DBS in respect of a bank guarantee of NIS 36 million, which DBS had provided in favor of the State of Israel, according to the terms of DBS's license. The guarantee was valid until December 31, 2010. This guarantee was in accordance with the proportionate rate of the Company's holdings in DBS when DBS was established. On January 24, 2011, the Company's Board of Directors approved the replacement of this guarantee with a new guarantee according to the updated proportionate rate of the Company's holdings in DBS (approximately 49.8% out of a total bank guarantee of NIS 38 million). The validity of the bank guarantee provided by the bank to the Ministry of Communications has since been extended (up to the end of April 2011) to allow finalization of the documents for the Company's new guarantee towards the bank that provided the bank guarantee.

E. In February 2002 and May 2005, according to Ministry of Communications requirements, Bezeq International provided bank guarantees of NIS 9.4 million and NIS 1.5 million respectively, for fulfillment of all the terms of the license to provide international telecommunication services. In February 2009, according to Ministry of Communications requirements, Bezeq International provided a bank guarantee of NIS 10 million to fulfill the terms of the special and general license for the provision of domestic operator services through the BIP Limited Partnership. At the reporting date, Bezeq International had provided additional bank guarantees in a total amount of NIS 16 million

F. Pelephone has bank guarantees of NIS 93 million in favor of third parties, of which NIS 35 million is in favor of the Ministry of Communications, in connection with a guarantee for fulfillment of the terms of its license.

G. The other shareholder in DBS has pledged its shares in favor of the banks. In view of a negative pledge of the Company, the Company provided the banks with a perpetual guarantee for payment of the debts of DBS. The guarantee is up to a maximum amount equal to the percentage of the Company's holding in DBS, multiplied by the value of DBS as derived from realization of the pledged shares of the other shareholders. If the Company joins the sale when realizing the pledged shares of the other shareholders, the amount of the guarantee will not exceed the amount of the proceeds the Company will receive from realization of its shares in DBS. The note of guarantee includes numerous restrictions on the Company in realizing the shares it holds, and lists events of violation which, if committed, will enable the banks to call in the guarantee. Furthermore, the Company undertook to put its shares up for sale if the shares pledged to the bank are sold, and agreed that in the event of realization of collateral provided by the other shareholders, the Company would forgo repayment of shareholder loans provided for DBS and that the guarantee would also apply, with the required changes, to warrants which the Company will receive from DBS and to the right to receive them.

The shareholders in DBS, have made a commitment to the banks not to oppose the sale or other realization of their shares in DBS, which were pledged or for which a guarantee was provided (by the Company), in a way that will enable the banks to accomplish a friendly liquidation. The Company also undertook that if a negative pledge the Company gave in favor of its creditors is released, the Company will pledge its shares in DBS in favor of the banks as a first lien

NOTE 20 – SECURITIES, LIENS AND GUARANTEES (CONTD.)

H. For securities, liens and stipulations given by the Company and subsidiaries in connection with loan covenants and borrowings, see Note 14.

J. For the securities, liens and stipulations of DBS, see Notes 5, 7, 21(1) and 28 to the financial statements of DBS for 2010 attached to these financial statements.

NOTE 21 – CAPITAL AND CAPITAL RESERVES

A. Equity

	Registered		Issued and paid up	
	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
	Number of shares	Number of shares	Number of shares	Number of shares
Ordinary shares of NIS 1 par value each	**2,825,000,000**	2,749,000,000	**2,685,917,052**	2,659,727,630

B. Dividend Distribution Policy

In August 2009, the Board of Directors resolved to distribute a dividend to the shareholders of 100% of the semi-annual profit ("profit for the period attributable to the shareholders of the Company"), in accordance with the consolidated financial statements of the Company. Application of the policy to distribute a dividend is subject to the provisions of the law, including the distribution criteria prescribed in the Companies Law, and the estimation of the Board of Directors of the Company regarding the Company's ability to meet its existing and anticipated liabilities, taking into consideration the projected cash flow, the Company's operations and liabilities, the cash balance, its plans and position as will be from time to time and subject to the approval of the general meeting of the Company's shareholders regarding any specific distribution, as set out in the articles of association of the Company. Since the date of the resolution, the Company's dividend policy has not been changed.

C. Request to distribute dividends exceeding the Company's profits

On December 30, 2010, the Company's Board of Directors resolved to approve and to recommend that the general meeting of the Company's shareholders approve a distribution to the Company's shareholders ("the planned distribution") in the total amount of NIS 3 billion, a sum not in compliance with the earnings test as defined in Section 302 of the Companies Law, 5759-1999. The amount of the planned distribution will be distributed to the Company's shareholders in six equal semi-annual payments, from 2011 to 2013 (without interest or linkage payments), together with the Company's regular dividend distribution. On January 24, 2011, the general meeting of the Company's shareholders approved the planned distribution, subject to court approval. On January 26, 2011, the Company applied to the court for approval of the planned distribution. On March 4, 2011, the court ordered the Securities Authority to submit its position within seven days.

A liability for the planned distribution was not recorded in these financial statements.

NOTE 21 – CAPITAL AND CAPITAL RESERVES (CONTD.)

D. Dividends

The Company declared and paid dividends in 2009 and 2010 as follows:

	2010 NIS millions	2009 NIS millions
In May 2009, a cash dividend was distributed (NIS 0.3 per share)	**-**	792
In October 2009, a cash dividend was distributed (NIS 0.43 per share)	**-**	1,149
In May 2010, a cash dividend was distributed (NIS 0.917 per share)	**2,453**	-
In October 2010, a cash dividend was distributed (NIS 0.478 per share)	**1,280**	-
	3,733	1,941

On March 7, 2011, the Company's Board of Directors resolved to ask the general meeting of the Company's shareholders to approve the distribution of a cash dividend to the Company's shareholders in a total amount of NIS 1.163 billion. At the reporting date, the dividend has not yet been approved by the general meeting.

E. The Company also issued share options to employees, managers and senior employees in the Group (see Note 27).

F. Description of the reserves

Capital reserve for activities between the Company and a controlling shareholder
This reserve relates to benefits granted by the State as a controlling shareholder in the Company, to employees, in cash and in equity instruments of the Company.

Capital reserve for employee share options
This reserve relates to a benefit granted to employees by means of share-based payments.

Translation reserve
A translation reserve includes all the foreign currency differences arising from translation of financial statements of a consolidated partnership whose functional currency is a foreign currency.

Capital reserve for assets classified as available for sale
The capital reserve for assets classified as available for sale includes the net cumulative change in the fair value of available-for-sale financial assets, up to the date of derecognition or impairment of the investment.

Reserve for transactions with non-controlling interests
The reserve for transactions with non-controlling interests, while retaining control, include differences between the consideration paid or received for changes in non-controlling interests.

NOTE 22 – REVENUE

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Domestic fixed-line communications			
Fixed line telephony	**3,074**	3,247	3,472
Internet - infrastructure	**977**	862	790
Transmission, data communication and other	**939**	940	981
	4,990	5,049	5,243
Cellular			
Cellular services and terminal equipment	**4,300**	4,013	3,758
Sale of terminal equipment	**1,176**	1,119	692
	5,476	5,132	4,450
International communications, internet Services and NEP	**1,334**	1,276	1,263
Others	**187**	62	59
	11,987	11,519	11,015

NOTE 23 - SALARIES

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Salaries and incidentals:			
Operating	**1,764**	1,670	1,660
General and administrative	**692**	655	651
Share-based payments	**35**	45	73
Total salaries and incidentals	**2,491**	2,370	2,384
Less – salaries recognized in investments in property, plant and equipment and in intangible assets	**467**	380	223
	2,024	1,990	2,161

NOTE 24 – OPERATING AND GENERAL EXPENSES

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Cellular telephone expenses	**1,866**	1,750	1,725
General expenses	**1,184**	1,140	1,008
Materials and spare parts	**1,049**	1,003	831
Building maintenance	**265**	295	204
Services and maintenance by sub-contractors	**107**	146	312
International communication expenses	**325**	313	272
Vehicle maintenance expenses	**132**	124	158
Royalties to the State of Israel	**74**	66	116
Collection fees	**24**	34	34
	5,026	4,871	4,660

NOTE 25 - OTHER OPERATING EXPENSES (INCOME), NET

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Provision for severance pay on early retirement	**36**	267	165
Capital gain from sale of property, plant and equipment (mainly real estate)	**(171)**	(64)	(18)
Profit from gaining control in an investee	**(57)**	-	-
Provision for contingent liabilities, net	**(35)**	(2)	(5)
Loss from copper forward transactions	**12**	-	-
Capital gain from sale of satellite communication operations	**-**	-	(50)
Impairment of long-term loans and others	**(1)**	-	4
	(216)	201	96

NOTE 26 – FINANCING EXPENSES (INCOME), NET

	Year ended December 31		
	2010	**2009**	**2008**
	NIS millions	**NIS millions**	**NIS millions**
Interest expenses for financial liabilities	**217**	185	192
Linkage and exchange rate differences, net	**64**	140	191
Net change in fair value of financial assets measured at fair value through profit or loss	**-**	-	24
Financing expenses for employee benefits, net	**20**	24	52
Other financing expenses	**90**	49	35
Total financing expenses	**391**	398	494
Interest and linkage differences from loans to an associate	**159**	198	189
Interest revenue from bank deposits, investments and other	**7**	16	62
Net change in fair value of financial assets measured at fair value in profit or loss (mainly for forward transactions)	**2**	61	-
Income in respect of credit in sales, net of discount commission	**87**	83	69
Revenue from financial assets classified as available for sale	**-**	23	-
Other financing income	**27**	48	34
Total financing income	**282**	429	354
Financing expenses (income), net (1)	**109**	(31)	140
(1) Less discounted amounts	**3**	6	35
Expenses recognized directly in other comprehensive income	**-**	-	5

NOTE 27 – SHARE-BASED PAYMENTS

A. In February 2007, the Board of Directors of the Company approved an employee share options plan for 3% of the issued and paid up capital of the Company, under the collective agreement with the employees of December 2006. On March 25, 2007, 78,092,000 options were allocated, and on January 2, 2008 another 59,000 options were allocated to two employee-directors. The options vested immediately. The value of the grant was determined at February 22, 2007, which is the grant date. The expenses in respect of this grant were recorded in 2006, since in that year an undertaking was made to the employees, including the terms of the grant. According to this plan, the last date for exercising the options is March 24, 2012.

B. On November 20, 2007, the Board of Directors of the Company resolved to adopt a new share options plan for managers and senior employees in the Company and/or in associates, which would allocate up to 65,000,000 unmarketable options exercisable for up to 65,000,000 shares of the Company and representing 2.5% of the issued capital of the Company, and at full dilution, 2.37% of the share capital.

The options plan and the allocation of the options under it, were approved by the general meeting of the Company on January 31, 2008, in accordance with the Company's Articles of Association. Exercise of the options under the plan was contingent upon obtaining the necessary approvals as prescribed in the provisions of the Telecommunications Order (Telecommunications and Broadcasts) (Determination of Essential Service Provided by Bezeq The Israel Telecommunication Corp. Ltd.), 5757-1997 (the Telecommunications Order) if the holdings of the controlling shareholder of the Company fall below the minimum prescribed in the Telecommunications Order (30%).
In February 2011, the Prime Minister and Minister of Communications approved the decrease of the holding below the negligible amount to 29%, provided the decrease arises from allocation of the Company's shares in an exercise of employee options, for six months from the date of the decrease below the negligible rate. The approval is effective at the date of the decrease below the negligible rate. The approval will expire after six months and the negligible rate will remain in effect.

The options will vest in three equal annual tranches. The vesting dates of each tranche will fall at the end of each of the first, second and third years after the grant date, respectively, and the expense for each tranche will be spread over its vesting period. In addition, the plan sets terms which, if met, accelerate the vesting date. Exercise of the options for shares will be by using a cashless exercise mechanism, unless the Board of Directors decides otherwise.

Of the options for managers and senior employees, at the date of the financial statements, 65,250,000 options have actually been allocated (of this amount, 6,199,999 options have been forfeited and returned to the quantity of options for allotment), as follows:

(1) 56,250,000 options, with a fair value of NIS 156 million of which 17,750,000 options, which were allotted in 2008 to the CEO of the Company and to senior officers who are key personnel in the Group with a theoretical economic value of NIS 45 million and 100,000 options, which were allotted in 2009 to an employee director with a theoretical economic value of NIS 303,000. The grant date was set as the later of the date of the general meeting and the date of the notice to the employees.

The exercise price set for the allotment of 49,950,000 options (out of 56,250,000, as set out above), is NIS 5.5 (adjusted for distribution of a dividend in cash or in kind). On June 26, 2008, the Board of Directors of the Company resolved that the exercise price for future allotments of options, as will be approved by the Board of Directors from time to time, will be the same as the average closing price of the Company's share on the stock exchange in the 30 trading days prior to the date of the board's decision to allot options to these offerees.

On December 31, 2009, the Board of Directors approved a retention plan for senior officers in the Group (CEOs of the Company, Pelephone and Bezeq International). According to the plan, their option agreements were amended so that in the event of dismissal within one year (compared to six months under the outline) from the date of transfer of control (April 14, 2010), the vesting period of the balance of the unvested options at the dismissal date will be accelerated. The amendment to the options agreements did not affect the financial statements of 2010 and is not expected to have any other material effect.

NOTE 27 – SHARE-BASED PAYMENTS (CONTD.)

B. (contd.)

(2) On April 17, 2008, the Board of Directors of the Company resolved to allocate 9,000,000 options to the chairman of the Board of Directors for that period in accordance with the plan described above, subject to a number of changes relating to the terms of his options. The allocation to the chairman was approved by the general meeting of the shareholders of the Company on June 1, 2008.

The options will vest in 12 equal quarterly tranches. The vesting dates of each tranche will fall at the end of each quarter from the grant date, and the expense will be spread for each tranche in accordance with its vesting period. In addition, the plan sets terms which, if met, accelerate the vesting date.
The exercise price of each option is NIS 6.4405 per share. The price was set according to the share price on the date on which the chairman took up his post – September 4, 2007 (which was NIS 6.649 per share) and after adjustment for distribution of a net dividend in the amount of NIS 0.26 per share, for which the ex-day was April 14, 2008. The closing price of the Company's share on June 1, 2008, the date of approval by the general meeting, was NIS 6.494 per share.

The grant date fair value of the options granted to the chairman as described above, according to a weighted Black and Scholes model, is NIS 16 million.

C. On December 19, 2010, the Board of Directors of the Company approved the amendment to the collective agreement with the employees (see Note 17D) and resolved to adopt a share options plan for employees ("the 2010 options plan for employees"). According to the 2010 options plan for employees, the Company will allocate 70,000,000 unmarketable options exercisable for up to 70,000,000 Company shares, par value NIS 1 each, representing 2.61% of the issued capital of the Company (2.5% at full dilution).

On December 20, 2010, the Company published an outline for the allocation of share options from the plan, in accordance with the Securities Regulations (Details of an Outline Offer of Securities to Employees), 5760-2000, which described, inter alia, the terms of the plan, and a private tender offer in accordance with the Securities Regulations (Private Placement of Securities in a Listed Company), 5760-2000

The options plan and the allocation of the options under it were approved by the general meeting of the Company in January 2011, in accordance with the Company's Articles of Association. Exercise of the options under the plan was contingent upon obtaining the necessary approvals as prescribed in the provisions of the Telecommunications Order (Telecommunications and Broadcasts) (Determination of Essential Service Provided by Bezeq The Israel Telecommunication Corp. Ltd.), 5757-1997 (the Telecommunications Order) if the holdings of the controlling shareholder of the Company fall below the minimum prescribed in the Telecommunications Order (30%).
In February 2011, the Prime Minister and Minister of Communications approved the decrease of the holding below the negligible amount to 29%, provided the decrease arises from allocation of the Company's shares in an exercise of employee options, for six months from the date of the decrease below the negligible rate. The approval is effective at the date of the decrease below the negligible rate. The approval will expire after six months and the negligible rate will remain in effect.

The options will vest in three equal annual tranches. The vesting dates of each tranche will fall at the end of each of the first, second and third years after the grant date, respectively, and the expense for each tranche will be spread over its vesting period. In addition, the plan sets terms which, if met, accelerate the vesting date. Exercise of the options for shares will be by using a cashless exercise mechanism.

Of the options for managers and senior employees, at the approval date of the financial statements, 67,464,814 options have actually been allocated, with a theoretical economic value of NIS 284 million, based on the Black- Scholes model. In addition, on January 25, 2011, the Company granted another 87,455 options, according to the plan, to two employee-directors. The theoretical economic value of the options granted to the chairman is NIS 384,000. The grant date is the date of approval by the general meeting. The theoretic economic value is calculated, inter alia, on the share price at the grant date. The date for recording the expense was set at December 19, 2010, the date the plan was approved by the Company's Board of Directors.

NOTE 27 – SHARE-BASED PAYMENTS (CONTD.)

D. Measurement of fair value at the grant date of the options

	Employee options plan for 2010	Options for the chairman of the Board of Directors	Options for senior employees
	Section C above	Section B(2) above	Section B(1) above
Weighted average of the fair value at the grant date	4.21	1.79	2.78
Share price	10.45-10.62	6.494	6.18-10.1
Exercise price	7.457	6.44	5.5-9.67
Expected volatility	25.8%-26.3%	23.11%	22.7%-26.6%
Contractual life of the option (in years)	2.5-4	4	4.5-5.6
Risk-free interest rate (based on government bonds)	3.2%-3.9%	5.1%	3.7%-5.7%

Due to the method for adjusting exercise increment to distribution of a dividend, an expected dividend percentage of 0% was assumed when calculating fair value.

The restriction described above by virtue of the Telecommunications Order was taken into account in calculating the theoretical economic value of the options, assuming that the restriction can be resolved.

E. Terms of the options for operating plans in the Company

Date of grant / eligible employees	No. of instruments (in thousands)	Vesting terms	Contractual life of the options
A. Grant of options to employees on February 22, 2007 (section A above)	78,151	Immediate (subject to lock-up for two years)	5 years
B. Grant of options to managers, senior employees and officers up to December 31, 2010 (section B above)	56,250	Three equal annual tranches	8 years
C. Grant to the chairman of the Board of Directors on April 17, 2008 (section B above)	9,000	12 quarterly tranches	4 years
D. Approval of 2010 option plan for employees (section C above)	67,552	Three equal annual tranches	5 years
Total share options granted	210,953		

The options referred to sections in A and B are settled by way of physical delivery of shares. The other options are settled in a cashless exercise mechanism.

NOTE 27 – SHARE-BASED PAYMENTS (CONTD.)

F. Number of options and weighted average of the exercise price

	Year ended December 31		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Balance as at January 1	**82,077**	223,399	200,849
Options granted during the year	**1,000**	2,700	61,550
Options forfeited during the year	**(933)**	(1,267)	(4,000)
Options exercised during the year	**(35,117)**	(142,278)	(35,000)
Options expired during the year	**-**	(477)	-
Balance at the end of the year	**47,027**	82,077	223,399
Exercisable at the end of the period subject to lock up	**-**	-	119,050
Exercisable at the end of the period, not subject to lock up	**27,741**	43,777	48,299

The average share price in 2010 and 2009 was NIS 9.38 per share and NIS 7.47 per share, respectively.

For the balance of the options issued at December 31, 2010, the exercise price is in the range of NIS 0.53 to NIS 8.27, and the weighted average of the remaining contractual life is 3.14 years.

G. Salary expense for share-based payments

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Equity-settled share options (1)	35	45	73

(1) Calculation of the salary expense assumed 5% for forfeiture, for each year, for the options plan set out in section B(1) above, and 1% for the options plan for employees in 2010.

H. Subsequent to reporting date and until March 6, 2011, the employees exercised an additional 2,596,000 options.

J. Cash-settled share-based payments

On December 30, 2010, the Company's Board of Directors adopted a plan for allocation of phantom options to senior managers in the Company and its subsidiaries. According to the terms of the plan, the options will be granted on the basis of a predefined allocation, at no cost, and will be exercisable into a cash grant. The exercise price of the option is based on the average adjusted share price in the 30 trading days preceding the date of approval by the Board of Directors. The exercise price is nominal and amounts to NIS 10.206. According to the plan, the options will vest in three equal annual tranches, and the contractual life of the options is five years. The expense will be spread for each tranche in accordance with its vesting period.

Up to December 31, 2010, 16,400,000 options were allocated, with a theoretical economic value of NIS 48 million, based on the Black-Scholes model (of which 8,000,000 options with a theoretical economic value of NIS 24 million were allocated to senior officers who serve in key positions in the Company). The value of the benefit will be measured in each quarter and any change in the fair value of the vested phantom options will be recognized in the statement of income.

NOTE 27 – SHARE-BASED PAYMENTS (CONTD.)

J. Cash-settled share-based payments (contd.)

Parameters used to measure fair value at the grant date of the phantom options:

Weighted average of the fair value at the grant date	2.95
Share price	10.82
Exercise price	10.206
Expected fluctuations	25.79%-26.35%
Contractual life of the option (in years)	3-4
Risk-free interest rate (based on government bonds)	3.47%-3.8%

K. For the options granted to the CEO of DBS, see Note 19 to the financial statements of DBS for 2010, which are attached to the Company's financial statements.

NOTE 28 – EARNINGS PER SHARE

Basic and diluted earnings per share

The calculation of basic earnings per share was based on the profit attributable to ordinary shareholders, and on a weighted average number of ordinary shares outstanding, calculated as follows:

	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Profit attributable to ordinary shareholders			
Profit attributable to ordinary shares from continuing operations	**2,443**	2,157	1,781
Profit (loss) attributable to ordinary shares from discontinued operations	**-**	1,446	(154)
Basic and diluted earnings for the year	**2,443**	3,603	1,627
Weighted average number of ordinary shares			
Weighted average number of ordinary shares (basic)	**2,675**	2,635	2,605
Effect of share options	**42**	49	44
Weighted average number of ordinary shares	**2,717**	2,684	2,649

The average market value of the Company's shares for purposes of calculating the dilutive effect of share options was based on quoted market prices for the period that the options were outstanding.

NOTE 29 – SEGMENT REPORTING

The Group operates in various segments in the communications sector, so that every company in the Group operates in one separate business segment. The primary reporting format, by business segments, is based on the Group's management and internal reporting structure.

Each company provides services in the segment in which it operates, using the property, plant and equipment and the infrastructure it owns. The infrastructure of each company is used only for providing its services. Each of the companies in the Group is exposed to different risks and yield expectations, mainly in the matter of the technology and competition in the segment in which it operates. Accordingly, the separable component in the Group is each company in the Group. From August 21, 2009, the Company no longer consolidates the reports of DBS in its financial statements and the investment in DBS is stated according to the equity method as from that date. The Group continues to report on multichannel television as a segment.

As from April 2010, the Company started to report the operations of Walla as an additional segment under Other Segments (see Note 5).

Based on the above, the business segments of the Group are as follows:

- Bezeq The Israel Telecommunication Corp. Ltd.: fixed line domestic communications
- communications cellular :.Ltd Communications Pelephone
- Bezeq International Ltd.: international communications, internet services and network end point
- DBS Satellite Services (1998) Ltd.: multichannel television

The other companies in the Group are presented under the "Other" item. Other operations include call center services (Bezeq Online), portal operations and content sites and online trading sites (Walla). These operations are not recognized as reporting segments as they do not fulfill the quantitative thresholds. The Group’s investment in the Stage One venture capital fund is presented under adjustments.

Inter-segment pricing is set at the price determined in a transaction between unrelated parties.

The results, assets and liabilities of a segment include items directly attributable to that segment, as well as those that can be allocated on a reasonable basis.

Segment capital expenditure is the total cost incurred during the period for acquisition of property, plant and equipment and intangible assets.

NOTE 29 – SEGMENT REPORTING (CONTD.)

A. Operating Segments

	Year ended December 31, 2010						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Revenue from external sources	4,990	5,474	1,333	1,578	178	(1,578)	11,975
Inter-segment revenue	273	258	47	5	32	(603)	12
Total revenue	5,263	5,732	1,380	1,583	210	(2,181)	11,987
Depreciation and amortization	690	601	94	285	15	(276)	1,409
Segment results – operating profit	2,043	1,383	320	178	14	(194)	3,744
Financing income	192	100	6	9	-	(25)	282
Financing expenses	(282)	(111)	(11)	(500)	(3)	516	(391)
Total financing income (expenses), net	(90)	(11)	(5)	(491)	(3)	491	(109)
Segment profit (loss) after financing expenses, net	1,953	1,372	315	(313)	11	297	3,635
Share in the (profits) losses of equity accounted investees	-	-	3	-	-	(264)	(261)
Segment profit (loss) before income tax	1,953	1,372	318	(313)	11	33	3,374
Income tax	527	339	65	1	4	(4)	932
Segment results – net profit (loss)	1,426	1,033	253	(314)	7	37	2,442
Additional information:							
Segment assets	6,352	4,892	1,032	1,243	291	(1,836)	11,974
Goodwill	-	-	6	-	84	1,090	1,180
Investment in associates	-	-	-	-	-	1,084	1,084
Segment liabilities	7,964	1,930	304	4,665	241	(6,236)	8,868
Capital expenses/contractual investments in property, plant and equipment and intangible assets	1,041	431	160	295	13	(295)	1,645

NOTE 29 – SEGMENT REPORTING (CONTD.)

A. Operating Segments

	Year ended December 31, 2009						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Revenue from external sources	5,039	5,130	1,273	1,529	54	(1,529)	11,496
Inter-segment revenue	264	246	45	1	20	(553)	23
Total revenue	5,303	5,376	1,318	1,530	74	(2,082)	11,519
Depreciation and amortization	794	603	84	234	4	(234)	1,485
Segment results – operating profit	1,523	1,190	261	248	4	(254)	2,972
Financing income	310	90	15	8	23	(17)	429
Financing expenses	(295)	(100)	(12)	(478)	-	487	(398)
Total financing income (expenses), net	15	(10)	3	(470)	23	470	31
Segment profit (loss) after financing expenses, net	1,538	1,180	264	(222)	27	216	3,003
Share in the (profits) losses of equity accounted investees	-	-	7	-	-	(41)	(34)
Segment profit (loss) before income tax	1,538	1,180	271	(222)	27	175	2,969
Profit from discontinued operations	-	-	-	-	-	1,379	1,379
Income tax	431	305	71	1	2	(3)	807
Segment results – net profit (loss)	1,107	875	200	(223)	25	1,557	3,541
Additional information:							
Segment assets	6,368	4,990	1,066	1,206	85	(2,026)	11,689
Goodwill	-	-	6	-	-	1,027	1,033
Investment in associates	-	-	34	-	-	1,185	1,219
Segment liabilities	6,390	2,440	404	4,314	22	(6,167)	7,403
Capital expenses/contractual investments in property, plant and equipment and intangible assets	838	508	151	270	3	(102)	1,668

NOTE 29 – SEGMENT REPORTING (CONTD.)

A. Operating Segments

	Year ended December 31, 2009						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Revenue from external sources	5,179	4,448	1,243	1,506	31	(1,506)	10,901
Inter-segment revenue	319	265	63	7	44	(584)	114
Total revenue	5,498	4,713	1,306	1,513	75	(2,090)	11,015
Depreciation and amortization	852	523	80	250	3	(250)	1,458
Segment results – operating profit	1,475	933	242	177	-	(187)	2,640
Financing income	236	117	7	52	1	(59)	354
Financing expenses	(361)	(115)	(8)	(493)	(18)	501	(494)
Total financing income (expenses), net	(125)	2	(1)	(441)	(17)	442	(140)
Segment profit (loss) after financing expenses, net	1,350	935	241	(264)	(17)	255	2,500
Share in earnings of equity-accounted investees	-	-	5	-	-	-	5
Segment profit (loss) before income tax	1,350	935	246	(264)	(17)	255	2,505
Loss from discontinued operations	-	-	-	-	-	(265)	(265)
Income tax	400	253	68	1	-	(3)	719
Segment results – net profit (loss)	950	682	178	(265)	(17)	(7)	1,521
Additional information:							
Segment assets	6,281	4,644	956	1,132	100	(624)	12,489
Goodwill	-	-	6	-	-	1,787	1,793
Investment in associates	-	-	32	-	-	-	32
Segment liabilities	6,037	2,552	284	4,024	29	(2,856)	10,070
Capital expenses/contractual investments in property, plant and equipment and intangible assets	600	911	120	265	2	-	1,898

NOTE 29 – SEGMENT REPORTING (CONTD.)

B. Adjustments for segment reporting of revenue, profit or loss, assets and liabilities

	Year ended December 31,		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Revenue			
Revenue from reporting segments	**13,958**	13,527	13,030
Revenue from other segments	**210**	74	75
Elimination of revenue from inter-segment sales except for revenue from sales to an associate reporting as a segment	**(603)**	(553)	(584)
Elimination of revenue for a segment classified as an associate (up to August 20, 2009 – discontinued operations)	**(1,578)**	(1,529)	(1,506)
Consolidated revenue	**11,987**	11,519	11,015

	Year ended December 31,		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Profit or loss			
Operating profit for reporting segments	**3,924**	3,216	2,817
Elimination of expenses from a segment classified as an associate(up to August 20, 2009 – discontinued operations)	**(178)**	(248)	(177)
Financing income (expenses), net	**(109)**	31	(140)
Share in the profits (losses) of equity-accounted investees	**(261)**	(34)	5
Profit for operations classified in other categories			
Others	**14**	4	-
Other adjustments	**(16)**	-	-
Consolidated profit before income tax	**3,374**	2,969	2,505

NOTE 29 – SEGMENT REPORTING (CONTD.)

B. Adjustments for segment reporting of revenue, profit or loss, assets and liabilities (contd.)

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Assets		
Assets from reporting segments	**13,525**	13,670
Assets attributable to operations in other categories	**375**	85
Goodwill not attributable to an operating segment	**1,090**	1,027
Investment in an equity-accounted investee (mainly loans) reported as a segment	**1,084**	1,185
Cancellation of assets for a segment classified as an associate	**(1,243)**	(1,206)
Less inter-segment assets	**(593)**	(820)
Consolidated assets	**14,238**	13,941

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Liabilities		
Liabilities from reporting segments	**14,863**	13,548
Liabilities attributable to operations in other categories	**241**	22
Cancellation of liabilities for a segment classified as an associate	**(4,665)**	(4,314)
Less inter-segment liabilities	**(1,571)**	(1,853)
Consolidated liabilities	**8,868**	7,403

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

A. Identity of interested and related parties

The Company's interested and related parties are as defined in the Securities Law and in IAS 24 – Related Party Disclosures and include mainly B Communications, related parties of B Communications, jointly-controlled entities, associates, directors and key management personnel in the Company or the parent company and a person who is close to a family member of any of these individuals.

B. Balances with interested and related parties

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Payables – associates, net	**58**	70
Loans to an associate, see section C below	**1,351**	1,165
Liabilities to related parties, net *	**(105)**	-
Loan from related parties to an associate *	**(1,351)**	-

* The amounts are for B Communications, the controlling shareholder of the Company as from April 14, 2010, and its related parties.

C. Loans provided to an associate

For the loans provided to an associate, DBS, see Note 13.

D. Transactions with interested and related parties

	Year ended December 31, 2010	2009	2008
	NIS millions	NIS millions	NIS millions
Revenue			
From associates	**172**	224	302
From the State of Israel **	**-**	-	273
From related parties *	**6**	-	-
Expenses			
To related parties *	**180**	-	-
Associate to related parties *	**106**	-	-
To associates	**5**	3	7
To the State of Israel (royalties) **	**-**	-	102
To the State of Israel (frequencies)**	**-**	-	21
Investments			
Rights to frequencies **	**-**	-	181
Related parties *	**78**	-	-

* The amounts are for B Communications, the controlling shareholder of the Company as from April 14, 2010, and its related parties.

** Up to September 25, 2008, when the State ceased to be an interested party in the Company. For other balances with related parties, see the relevant notes.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties

(1) Negligible transactions

On March 7, 2011, the Company's Board of Directors resolved to adopt guidelines and regulations to classify a transaction of the Company, its subsidiary or associate with an interested party as a negligible transaction, , as set out in Article 41(A)(6) of the Securities Regulations (Annual Financial Statements), 5770-2010 ("the annual financial statements regulations"). These guidelines and regulations are also used to examine the scope of disclosure in periodic reports and prospectuses (including shelf offering reports) regarding a transaction of the Company, a company under its control and a subsidiary or associate with a controlling shareholder or in which the controlling shareholder has a personal interest as set out in Article 22 of the Securities Law (Periodic and Immediate Reports), 5730-1970 ("the periodic reports regulations") and Article 54 of the Securities Regulations (Prospectus Details and Draft Prospectus – Structure and Form), 5729-1969, and to examine the need to submit an immediate report for the transaction of the Company, as set out in Article 37(A)(6) of the periodic reports regulations (types of transactions determined in the financial statements regulations, the periodic reports regulations and the prospectus details regulations referred to above

From time to time, the Company and its subsidiaries or associates carry out negligible transactions, which are not extraordinary transactions, with an interested party in the Company or with related parties, of the types and nature detailed below: Transactions for the sale or purchase of products and services, such as communication products and services, including fixed-line and cellular handsets, software development products and services, maintenance services, voice-mail services, rental transactions of real estate properties and advertising services.
In the absence of special, qualitative considerations in the circumstances, a transaction that is in the Company's regular course of business, is carried out in market conditions and has no material effect on the Company, shall be deemed negligible if all the following parameters exist:

a. The amount of the transaction does not exceed NIS 10 million.
b. The Company is not required to issue an immediate report for the transaction under Article 36 of the periodic reports regulations or any other law.
c. The transaction does not address the employment terms (as set out in the Companies Law) of the interested party.

According to the provisions of the Companies Law, 5769-1999, as may be from time to time, once a year, before publication of the annual financial statements, the audit committee will review the parameters set out above, and whether they require updating. In general, each transaction will be tested separately for negligibility. Notwithstanding the aforesaid, separate transactions that are part of the same continuing transaction or very similar transactions that are carried out routinely and repeatedly, will be tested as one transaction on an annual basis for negligibility, provided the scope of the transaction does not exceed NIS 10 million, as set out above.
The Board of Directors may, from time to time and at its discretion, amend the parameters for a negligible transaction. This amendment will be duly reported.

For details of transactions that are not within the above definition of negligible, see sections 2 and 3 below.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(2) Transactions with controlling shareholders or in which the controlling shareholder has a personal interest, pursuant to section 270(4) of the Companies Law, 5769-1999 ("the Companies Law").

A. Debt arrangements between the Company and Bezeq International and DBS

On May 20, 2010, the general meeting of the Company's shareholders approved an arrangement for DBS's debt to the Company for communication services, amounting to NIS 31.5 million at July 31, 2009, which DBS will pay the Company in 36 equal monthly payments of NIS 875,000 each plus VAT and interest at prime + 1.5% plus VAT for the interest.

On October 14, 2010, the general meeting of the Company's shareholders approved the Company's agreement with DBS with an amendment to the debt arrangement from May 2010 and September 2006. Under the amendments, all the payments that are due from July 1, 2010 to December 31, 2011 will be deferred for 18 months, against payment of annual interest of prime + 3% plus VAT for the interest. The deferred payments amount to NIS 45.4 million.

On October 14, 2010, the general meeting of the Company's shareholders approved the agreement of Bezeq International and DBS with an amendment to the debt arrangement from January 2010 (regarding DBS's debt to Bezeq International amounting to NIS 8,370,000 in 24 equal monthly payments for payment commencing from July 1, 2010 plus interest at prime + 1% and VAT). Under the amendment, each of these payments will be deferred for 18 months, against payment of annual interest of prime + 3% plus VAT for the interest. For the sake of caution, these transactions were approved as transactions in which a controlling shareholder in the Company has a personal interest, since the controlling shareholder of Eurocom DBS (a shareholder of DBS) is the controlling shareholder of the Company.

B. Approval of the settlement with Yacov Gelbard, former CEO of the Company

On May 20, 2010, the general meeting of the Company's shareholders approved the settlement agreement between the Company and Yacov Gelbard, former CEO of the Company (after approval of the audit committee and Board of Directors) in which all of the mutual claims of the parties are dismissed, including claims against other Group companies and their representatives.

Yacov Gelbard served as CEO of the Company from October 11, 2005. On April 30, 2007, Yacov Gelbard terminated his service as CEO of the Company, following a joint announcement by the parties on that date. After termination of his employment at the Company, disputes arose regarding the rights and moneys to which Yacov Gelbard is entitled for issues related to his employment and severance. The disputes included claims by Yacov Gelbard regarding his right to be included in the officers' options plan and the compensation to which he is entitled under this plan.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(2) (contd.)

B. Approval of the settlement with Yacov Gelbard, former CEO of the Company (contd.)

After negotiations between the parties and their representatives, the Company and Yacov Gelbard reached a settlement agreement. The main points of the settlement agreement are as follows: The Company will pay Yacov Gelman a lump sum of NIS 9 million (gross). After this payment, there will be no further accounting and/or demands in respect of amounts paid to Yacov Gelbard and/or returned by him during and/or after his employment (including amounts offset from Yacov Gelbard. The Company declares, in its name and on behalf of all Group companies, that they have no demands, claims or suits from Yacov Gelbard, including claims relating to the return of additional funds that the Company claims that Yacov Gelbard received in contravention of the law, and if they had such claims, they waive them fully and absolutely. This payment is without any admission of either party of the claims, demands or positions of the other party. For the sake of caution, the agreement was presented for approval at the general meeting under section 275 of the Companies Law, since the agreement included a waiver of the claims by Yacov Gelbard towards directors in the Company, and at the time the agreement was approved by the Company's Board of Directors, Ap.Sr.Ar. Holdings Ltd. was a controlling shareholder in the Company and some of the directors were considered as controlling shareholders in the Company at that time.

C. Management services

On June 10, 2010, the general meeting of the Company's shareholders approved an agreement between the Company and Eurocom Communications Ltd., the controlling shareholder (indirect) of the Company. Under the agreement, Eurocom will provide the Company with ongoing management and consultation services for an annual fee of USD 1.2 million over three years, commencing from June 1, 2010 through to May 31, 2013, unless one of the parties announces its intention to terminate the agreement with three-months notice. The main services provided by the management company are consultation services for the Company's operations, including strategy, business development, regulation, marketing and any other consultation that the Company requires as a communications company and as a group of companies, and ongoing management services.

The services will be supplied from June 1, 2010 and for the term of the agreement by managers and/or employees and/or consultants of the management company and/or its shareholders and anyone that the management company deems suitable to supply the services. The management company will provide professional and skilled human resources and other resources that are required to supply the services, including managers and consultants with a background in communications and with international experience, in order to provide the Group with professional and high-quality service. In addition, according the consultation agreement, until otherwise decided, the Company's directors, except for outside directors, independent directors and the chairman of the Board of Directors, will not receive directors compensation from the Company or the subsidiaries. The Company recognized expenses of NIS 2.541 million for the management services in 2010.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(2) (contd.)

D. Agreement for acquisition and supply of Nokia products

On June 10, 2010, the general meeting of the Company's shareholders approved an agreement between Pelephone and Eurocom Cellular Communications Ltd. for acquisition and supply of Nokia products to Pelephone (terminal equipment, spare parts and accessories) and maintenance services for these products. The agreement is valid from April 14, 2010 to December 31, 2012. The amount of the annual purchases under the agreement will not deviate from a cumulative amount of NIS 450 million per year (the calculation for 2010 will be made from the beginning of the year). Any purchases exceeding this amount will be subject to prior approval by law. An annual increase of up to NIS 45 million will only require the approval of the Company's audit committee and Board of directors, as well as the approval of the certified agents of Pelephone and Eurocom. The shareholders in Eurocom Cellular Communications Ltd. are the shareholders of the Company. Pelephone recognized expenses of NIS 163 million for the agreement.

E. Authorization to sell routers

On October 14, 2010, the general meeting of the Company's shareholders approved an agreement between the Company and DBS. Under the agreement, DBS will be allowed to sell its customers a wireless router of the Company, according to the terms of the agreement with the Company which are in effect at the time, and to deliver and install the router, with no charge. The transaction was approved as a transaction in which the controlling shareholders in the Company have a personal interest, since the controlling shareholders of Eurocom DBS (a shareholder of DBS) are the controlling shareholder of the Company. In the reporting year, the authorization was not implemented.

F. Reciprocal marketing agreement between the Company and DBS

On October 14, 2010, the general meeting of the Company's shareholders approved an arrangement between the Company and DBS for reciprocal marketing of products and services. According to the arrangement, the Company may market DBS services (satellite television) and DBS may market the Company's services (ADSL internet, telephony and value added services). The transaction was approved as a transaction in which the controlling shareholders in the Company have a personal interest, since the controlling shareholders of Eurocom DBS (a shareholder of DBS) are the controlling shareholder of the Company. In the reporting year, the agreement was not implemented.

G. Reciprocal marketing agreement between Bezeq International and DBS

On October 14, 2010, the general meeting of the Company's shareholders approved an arrangement between Bezeq International and DBS for reciprocal marketing of products and services. According to the arrangement, Bezeq International may market DBS services (satellite television) and DBS may market the Company's services (internet access, international calls, VoB and value added services). The transaction was approved as a transaction in which the controlling shareholders in the Company have a personal interest, since the controlling shareholders of Eurocom DBS (a shareholder of DBS) are the controlling shareholder of the Company. In the reporting year, the agreement was not implemented.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(2) (contd.)

H. Agreement for acquisition of converters

On July 29, 2010, the general meeting of the Company's shareholders approved an agreement between DBS and Advanced Digital Broadcast SA and Eurocom Digital Communications Ltd. for the purchase of 47,500 yesMaxHD converters at a cost of USD 9,796,400 and receipt of dollar credit from Eurocom for an additional 60 days for the purchase of the converters. The general meeting resolved that the Company should vote in favor of the transaction in the general meeting of the shareholders of DBS. For the sake of caution, the agreement was presented at the general meeting of the Company's shareholders pursuant to section 275 of the Companies Law, in view of the terms set out in the Ministry of Communications' approval, as a transaction for acquisition of control in the Company by B Communications. The investment in the converters was stated in the financial statements of DBS in 2010 under property, plant and equipment.

On March 7, 2011, the Company's Board of Directors approved an agreement with DBS (after approval of the audit committee), as follows:

(1) An additional order of yesMaxHD converters from Eurocom Digital Communications and ADB, according to the framework agreement and any upgrade (partial or full, at the discretion of DBS) of the converter's hard-drive, at a total cost of USD 10.3 million. This price is for sea shipment. Should DBS require earlier delivery that requires air shipment, DBS will pay Eurocom the extra cost for air delivery.

(2) Receipt of dollar credit from Eurocom Digital Communications for an additional 60 days ("the additional credit period") for purchase of the converters. The payment terms set out in the framework agreement is EOM + 35 and for the additional credit period, DBS will pay interest at a rate of 1% (6% in nominal annual terms). The scope of the credit is estimated at an average of NIS 11 million and payment of the annual interest is estimated as NIS 578,000.

(3) An order of power supplies for yesMaxHD converters from Eurocom Digital Communications and from ADB, until May 31, 2012, at a total cost of USD 130,000.

For the sake of caution, the agreements were presented for approval at the general meeting under section 275 of the Companies Law, in view of the terms set out in the Ministry of Communications' approval, as a transaction for acquisition of control in the Company by B Communications.

I. Officers insurance

On March 8, 2010, the general meeting of the Company's shareholders approved (after approval of the audit committee and the Board of directors) the conversion of the directors' and officers' liability insurance policy to a run-off policy, commencing from the date of transfer of control from Ap.Sb.Ar. Holdings Ltd. to B Communications for seven years from this date. The limit of liability is up to USD 50 million for claims and in total for the insurance period. In addition, the liability limit is up to USD 10 million per claim and in total for the insurance period for legal expenses in Israel only. The liability limit for subsidiaries is half of this amount (as part of the above liability limit). The annual premium for the policy is USD 380,500. The policy will also cover directors who were controlling shareholders in the Company until control was transferred to B Communications, or their relatives.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(2) (contd.)

J. Undertaking to indemnify in advance for new directors in the Company

On June 10, 2010, the general meeting of the Company's shareholders approved the undertaking to indemnify in advance directors who are controlling shareholders in the Company and/or their relatives, In addition, approval was asked to indemnify the other new directors who are controlling shareholders of the company and/or their relatives.

The liability will be provided in a deed of indemnity that is similar to the deed of indemnity granted to the other officers in the Company, as set out below:

(1) Undertaking to indemnify the Company's officers for any liability or expense imposed on the officers due to their actions in their capacity as an officer in the Company (including their actions in subsidiaries), within the limitations provided in the Companies Law.

(2) The total amount of the indemnity was limited to a ceiling of 25% of the equity of the Company as may be at the time of actually paying the indemnity.

K. Continuation of the D&O liability insurance policy

On November 22, 2010, the general meeting of the Company's shareholders approved the continuation of the Company's D&O liability insurance policy, which was approved by the Company's Board of Directors on January 28, 2010, under the framework transaction that was valid until October 10, 2010. The general meeting approved the continuation of the policy from that date until the end of the term of the existing policy, which is April 13, 2011.
Terms of the existing insurance policy:

(1) Policy covering the liability of directors and officers in the Company, as they may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, all the directors and officers in companies in which the Company holds 50% or more, directors and officers representing the Company in companies in which the Company holds less than 50%, and senior employees who are not officers for managerial actions taken by them.

(2) Limits of liability: The liability limit is USD 50 million per claim and in total for all claims in the insurance period. In addition, USD 10 million per claim and in total for each year of insurance for legal expenses in Israel only. The liability limit for subsidiaries is half of this amount (as part of that liability limit).

(3) The annual premium for the policy is USD 140,000. The policy also covers directors who are controlling shareholders in the Company.

L. Agreement for supply of space segments to DBS from Space Communications Ltd. ("Spacecom")

DBS has a series of agreements with Spacecom, a company controlled by Eurocom Holdings and Eurocom Communications, for the use of space segments via Amos 2 and Amos 3 satellites. DBS paid Spacecom usage fees of NIS 87 million in 2010. These agreements were signed before B Communications acquired control in the Company, therefore at the date the agreements were signed, the approval of the Company's agents was not required pursuant to Chapter 5 in Part VI of the Companies Law.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(2) (contd.)

M. Framework transaction for D&O liability insurance

On March 7, 2011, the Company’s Board of Directors approved, after approval of the audit committee, a framework transaction, subject to approval of the general meeting of the Company’s shareholders, for three years, from April 14, 2011 through to April 13, 2014, for the Company's engagement, during the normal course of business, in future insurance policies to cover the liability of directors and officers as may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, and all by way of a "framework transaction" as defined in the Companies Regulations (Reliefs in Transactions with an Interested Party), 5760-2000 (“the relief regulations”). The Company will acquire a policy with a liability limit of USD 100 million per claim and in total for each insurance year, and up to USD 20 million per claim and in total for the insurance period for legal expenses in Israel only. In addition, the liability limit for subsidiaries is the aggregate of half of this amount (as part of the above liability limits). The amount of the annual premium that the Company pays will not exceed USD 185,000 plus a sum constituting up to 20% of that amount. The Company may purchase insurance with a liability limit exceeding USD 100 million, provided that the amount of the annual premium that the Company pays does not exceed USD 185,000 plus a sum constituting up to 20% of that amount. Any purchase of a new insurance policy in the future as mentioned above will be approved by the Company’s audit committee and the Board of Directors, which will determine whether it complies with the terms of the framework transaction.

N. D&O liability insurance policy

On March 7, 2011, the Company’s audit committee and Board of Directors approved the Company’s engagement in a D&O liability insurance policy for one year, from April 14, 2011 through to April 13, 2012. The Company will pay an annual premium of up to USD 185,000. The liability limit is USD 100 million per claim and in total for each insurance year, and up to USD 20 million per claim and in total for the insurance period for legal expenses in Israel only. In addition, the aggregate liability limit for subsidiaries is half of this amount (as part of the above liability limits). The transaction requires approval of the general meeting. For directors who are controlling shareholders, or their relatives, the engagement was approved pursuant to article 1B(5) of the relief regulations. Accordingly, if an objection is submitted as set out in article 1(C)(a) of the relief regulations, for the scope of the policy in respect of directors who are controlling shareholders or their relatives, the engagement is subject to the approval of the general meeting with a majority as set out in section 275 of the Companies Law.

(3) Transactions not included in section 270(4) of the Companies Law and are not negligible

A. Raising of debt by DBS

On November 2, 2010, the Company’s audit committee and Board of Directors resolved that the Company will vote at the general meeting of the shareholders of DBS in favor of DBS’s transaction to raise debt in the amount of NIS 450 million.
On March 7, 2011, the Company’s Board of Directors resolved (after the approval of the audit committee) that the Company will vote at the general meeting of the shareholders of DBS in favor of DBS’s transaction to raise debt in the amount of up to NIS 120 million.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(3) (contd.)

B. Acquisition of converters and settlement agreement to dismiss mutual claims

On March 7, 2011, the Company's Board of Directors approved (after approval of the audit committee), a settlement agreement with Pace Micro Technology Plc ("Pace") to dismiss the claim filed in 2006 against Pace by DBS (principal of NIS 32 million) and the counterclaim filed by Pace against DBS and against Eurocom Digital Communications (principal of NIS 43 million). According to the settlement agreement, all the litigation between the parties will be terminated, without any party admitting to the claim of the other party. DBS will purchase converters from Pace (in an amount of USD 4.158 million) and Pace will supply DBS, at no cost, an additional amount of converters (equivalent to USD 1.8 million, according to the terms of the purchase agreement for the converters). Eurocom Digital Communications is controlled by the controlling shareholder (indirectly) of Eurocom DBS, a shareholder in DBS.

F. Benefits for key managers

Benefits for employment of key managers, including:

	Year ended December 31					
	2010		2009		2008	
	No. of persons	NIS thousands	No. of persons	NIS thousands	No. of persons	NIS thousands
Salary (2)	**4**	**7,701**	4	9,544	5	10,355
Bonus (3)	**4**	**13,366**	4	8,713	5	8,959
Share-based payments, see Note 27	**4**	**7,141**	4	15,712	5	30,024
		28,208		33,969		49,338

(1) Key managers in the Group in 2010 include the chairman of the board and the CEO of the Company, as well as the CEOs of Pelephone and Bezeq International. In 2008, the CEO of DBS was also included among the key managers.

(2) In 2010, the changes in other provisions (which are included in total salary) were not significant, except for a decrease in the provisions for early notice and leave for the chairman of the Board of Directors, in the amount of NIS 1.8 million. In 2009, the changes in the other provisions were not significant. In 2008, the changes in the other provisions were not significant, except for a decrease in the provision for notice for the CEO of the Company, in the amount of NIS 746,000, in accordance with his employment agreement.

(3) The bonus for 2010 to the chairman of the board, amounting to NIS 3.507 million, requires the approval of the general meeting of the shareholders of the Company. In addition, the bonus includes a retention grant for the CEO's of the Company, Bezeq International and Pelephone, amounting to nine months salary, and was approved by the Company's Board of Directors on December 31, 2009.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(3) (contd.)

G. Benefits for directors

	Year ended December 31,		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Remuneration for directors who are not employed by the Company	**966**	705	619
Number of directors receiving remuneration	**5**	2	3
Salary of employee-directors (2)	**1,332**	1,450	1,120
Number of directors receiving the salary	**2**	2	2
Management fees to the controlling shareholder until April 14, 2010	**1,285**	4,692	4,238
Management fees to the controlling shareholder from April 14, 2010 See section E(2)(c)	**2,541**	-	-

(1) The directors serving on the Company's Board of Directors, except for the outside directors and the independent directors, do not receive remuneration from the Company.

(2) The salary is paid to employee-directors in respect of their work in the Company and they do not receive any additional pay in respect of their service as directors in the Company. For details of the options that were allocated to employee-directors according to the 2007 senior officers options plan, see Note 27B(1). For details of the additional allocation of options for employee-directors on January 25, 2011, see Note 27C.

(3) In May 2005, the general meeting of the Company's shareholders approved the exercise of an option to purchase a run-off policy for liability for officers who served in the Company up to transfer of control to Ap. Sr. Ar., meaning until October 11, 2005, for seven years from that date.

(4) In December 2007, the general meeting of the Company's shareholders approved a framework transaction for the Company's engagement, during the normal course of business, in future insurance policies to cover the liability of directors and officers as may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, all the officers in companies in which the Company holds 50% or more, officers representing the Company in companies in which the Company holds 50% or more, and senior employees who are not officers, for managerial actions taken by them, and all by way of a "framework transaction" as defined in the Companies Regulations (Reliefs in Transactions with an Interested Party), 5760-2000, at an annual premium of up to USD 510,000 plus a sum constituting up to 20% of that premium in respect of the current insurance cover.

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(3) (contd.)

G. Benefits for directors (contd.)

(5) In December 2009, the Board of Directors of the Company approved the renewal of a liability insurance policy for officers in the Company, under the framework agreement approved by the general meeting of the Company's shareholders on December 26, 2007. This was effective from November 1, 2009 to October 10, 2010 (with an option to extend the policy until October 31, 2010, for no further consideration, subject to due approval). The liability limit is USD 100 million per claim and in total for all claims in the insurance period. In addition, the liability limit is up to USD 20 million per claim and in total for the insurance period for legal expenses in Israel only. The liability limit for subsidiaries is USD 50 million (as part of the aforementioned liability limit). The annual premium for the policy is USD 313,650.

(6) In January 2010, the Board of Directors of the Company approved an agreement to purchase a D&O insurance policy, under the framework agreement that was approved by the general meeting of the Company's shareholders on December 26, 2007. This policy is effective from the expiry date of the D&O liability insurance policy (which is the date of transfer of control from Ap.Sb.Ar. Holdings Ltd. to 012 Smile Communications Ltd. as set out in the immediate report issued by the Company on January 31, 2010 regarding convening a general meeting) and up to October 10, 2010. The liability limit is up to USD 50 million for claims and in total for each insurance year. In addition, the liability limit is up to USD 10 million per claim and in total for the insurance period for legal expenses in Israel only. The liability limit for subsidiaries is half of this amount (as part of the above liability limit). The annual premium for the policy is up to USD 188,500. It is clarified that this policy replaces the existing insurance policy, which was approved by the Board of Directors of the Company on December 10, 2009.

(7) For details of the approval of the general meeting held in March 2010 and November 2010 in respect of D&O liability insurance, see section E(2)(i) and E(2)(k) above, respectively.

(8) For details of the approval of the Board of Directors in March 2011 in respect of the framework transaction for D&O liability insurance, see section E(2)(m) above.

(9) For details of the decision of the audit committee and Board of Directors in respect of the approval in March 2011 in respect of the D&O liability insurance, see section E(2)(n) above.

(10) In January 2007, the general meeting of the Company's shareholders approved an undertaking to indemnify according to a deed of indemnity for all of the Company's officers for any liability or expense imposed on the officers due to their actions in their capacity as an officer in the Company (including their actions in subsidiaries), within the limitations provided in the Companies Law. The amount of the indemnity was limited to a ceiling of 25% of the Company's equity as may be at the time of actually paying the indemnity. The deed of indemnity will apply events listed in the deed of indemnity, which is attached to the immediate report regarding notice of a general meeting to approve the undertaking to indemnify. In 2008-2010 and up to the publication date of this report, an undertaking to indemnify was approved for new officers who joined the Company. In the past seven years, the Company has granted indemnity to officers for the following issues:

NOTE 30 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

E. Transactions with interested and related parties (contd.)

(3) (contd.)

G. Benefits for directors

(10) (contd.)

a. Undertaking in advance to indemnify officers for any expense or financial liability imposed on them for litigation related to the Company's prospectus of May 2004.

b. Undertaking in advance to indemnify officers who served in the Company when the undertaking to indemnify was granted or who served during the seven years preceding this date, for expenses or financial liabilities arising from a claim of a shareholder who held at any time during the four years preceding the date of the liability 15% or more of the Company's issued share capital.

c. Undertaking in advance to indemnify officers who served in the Company when the undertaking to indemnify was granted or who served during the seven years preceding this date, to grant a loan to finance reasonable litigation expenses, including a class action. The loan will become a grant if the court does not impose liabilities on the officer in a peremptory ruling.

d. Undertaking to officers that the insurance coverage for events covered in the D&O insurance policy acquired by the Company in 2003, will continue for seven years, provided the cost of the insurance premium is reasonable.

e. The undertaking to indemnify of April 6, 2005 for a financial liability that would be imposed on officers of the Company and in respect of reasonable litigation expenses which they would incur, relating directly or indirectly to the sale of the State's holdings in the Company.

f. The undertaking to indemnify of May 16, 2005, for officers who served in the seven years preceding the completion date of the sale of core control in the Company to Ap.Sb.Ar.

H. For guarantees to related parties, see Note 20.

J. For the allocation of phantom options to the CEOs of the Company, Pelephone and Bezeq International, see Note 27.

NOTE 31—FINANCIAL RISK MANAGEMENT

A. General

The Group is exposed to the following risks, arising from the use of financial instruments:

- it riskCred
- Liquidity risk
- Market risk (which includes currency, interest, inflation and other price risks)

This Note provides information about the Group's exposure to each of the above risks, an explanation as to how the risks are managed, and the measurement processes. Other quantitative disclosure is included in the other Notes to the financial statements.

NOTE 31—FINANCIAL RISK MANAGEMENT (CONTD.)

B. Framework for risk management

The Board of Directors has overall responsibility for the Group’s risk management. The purpose of risk management in the Group is to define and monitor those risks constantly, and to minimize their possible effects arising from the exposure on the basis of assessments and expectations for parameters that affect the risks. The Group's policy is to hedge, in part and where required, exposure from fluctuations in foreign exchange rates, copper prices, the CPI and interest rates.

C. Credit risk

Credit risk is the risk of financial loss to the Group if a customer or the other party to a financial instrument fails to meet its contractual obligations, and it is derived mainly from debit balances of customers and other receivables and from investments in deposits and in securities.
Management monitors the Group's exposure to credit risks on a regular basis. Cash and investments in deposits and securities are deposited in highly-rated banks and credit assessments are made on material customer balances.

Trade and other receivables
The Group's management regularly monitors customer debts, and the financial statements include provisions for doubtful debts which properly reflect, in the management's estimation, the loss inherent in doubtful debts. In addition, the balances of the trade receivables are widely spread.

Investments
Any investments in securities are made in Government securities and in investment-grade companies, which are liquid and marketable. Transactions involving derivatives are made with entities that have a high credit rating.

Guarantees
The Group's policy is to provide tender, performance and legal guarantees. In addition, the Company provides bank guarantees, where necessary, for banking obligations of subsidiaries. At December 31, 2010, the Group has the guarantees described in Note 20.
At the reporting date, there is no material concentration of credit risks. The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivatives, in the statement of financial position.

D. Liquidity risk

Liquidity risk is the risk that the Group will be unable to honor its financial obligations on time. The Group's policy for liquidity management is to ensure, as far as possible, that it will always have sufficient liquidity to honor those liabilities on time, without incurring undesirable losses. In addition, for debentures issued by the Company, see Note 14B(2) and for debentures issued by a subsidiary, see Note 14B(3).

E. Market risks

Market risk is the risk that changes in market prices, such as foreign currency exchange rates, interest rates and the prices of securities, raw materials and other items, will influence the Group's results or the value of its holdings in financial instruments. The purpose of market risk management is to manage and oversee the exposure to market risks within accepted parameters to prevent significant exposures to market risks that will influence the Group's results, liabilities and cash flow in the short term (up to one year).
During the normal course of its business, the Group takes full or partial hedging action and takes into account the effects of the exposure in its considerations for determining the type of loans it takes and in managing its investment portfolio.

NOTE 31—FINANCIAL RISK MANAGEMENT (CONTD.)

E. Market risks (contd.)

CPI risk
Changes in the rate of inflation affect the Group's profitability and its future cash flows, mainly due to its CPI-linked liabilities. The Group has surplus liabilities over assets linked to the CPI. In applying a policy of minimizing the exposure, the Group makes forward transactions against the CPI. The duration of the forward transactions is the same as or shorter than the duration of the hedged exposures. A considerable part of these cash balances is invested in deposits which are exposed to changes in their real value as a result of a change in the rate of the CPI.

Foreign currency risk
The Group is exposed to foreign currency risks mainly due to dollar-linked and euro-linked payments for purchases of terminal equipment and property, plant and equipment. In addition, it provides services for customers and receives services from suppliers worldwide for which it is paid and it pays in foreign currency, mainly the dollar. The Group has surplus liabilities over assets in foreign currency. In applying a policy of minimizing the exposure, the Group makes forward transactions and purchases options against the dollar. The duration of the hedging transactions is the same as or shorter than the duration of the hedged exposures.

Interest risks
The Group is exposed to changes in the fair value of its liabilities as a result of borrowings at fixed interest. The Group is also exposed to changes in its cash flows as a result of borrowings at variable interest.

NOTE 32 – FINANCIAL INSTRUMENTS

A. Credit risk

The carrying amount of the financial assets represents the maximum credit exposure. Maximum exposure to credit loss at the reporting date:

	December 31,	
	2010	2009
	NIS millions	NIS millions
Cash and cash equivalents	**365**	580
Financial assets held for trading	**-**	141
Available-for-sale financial assets	**31**	37
Trade and other receivables	**3,920**	3,461
Bank deposit for providing loans to employees	**83**	83
Assets and other investments	**7**	-
Derivatives	**15**	23
	4,421	4,325

See Note 8 for the matter of maximum exposure to credit risk for trade receivables.

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

B. Liquidity risk

Below are the contractual repayment dates of financial liabilities, including estimated interest payments.

	December 31, 2010						
	Carrying amount	Contractual cash flow	6 months or less	6-12 months	1-2 years	3-5 years	More than 5 years
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Non-derivative financial liabilities							
Trade payables	1,061	1,061	1,061	-	-	-	-
Other payables	760	760	748	12	-	-	-
Bank loans	2,855	3,320	69	83	310	1,778	1,080
Debentures issued to the public	2,163	2,391	690	-	371	1,021	309
Debentures issued to financial and other institutions	699	756	169*	79	152	356	-
	7,538	8,288	2,737	174	833	3,155	1,389
Financial liabilities - derivatives							
Forward contracts on copper prices	10	10	10	-	-	-	-

* Including debentures of the Company amounting to NIS 77 million, stated in the financial statements as short term due to non-compliance with financial covenants. See Note 14C (1)

It is not expected that the cash flows included in the analysis of the repayment dates will be materially earlier, or in amounts that are materially different. For guarantees see Notes 14 and 20.

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

B. Liquidity risk –contd.)

	December 31, 2009						
	Carrying amount	Contractual cash flow	6 months or less	6-12 months	1-2 years	3-5 years	More than 5 years
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Non-derivative financial liabilities							
Trade payables	1,091	1,091	1,091	-	-	-	-
Other payables	695	695	681	14	-	-	-
Bank loans	622	681	32	51	138	441	19
Debentures issued to the public	2,476	2,797	395	-	738	1,044	620
Debentures issued to financial and other institutions	1,038	1,141	409*	80	155	429	68
	5,922	6,405	2,608	145	1,031	1,914	707
Financial liabilities - derivatives							
Forward contracts on currencies	1	1	1	-	-	-	-
Exchange rate options	1	1	1	-	-	-	-
	2	2	2	-	-	-	-

* Including debentures of the Company amounting to NIS 94 million, stated in the financial statements as short term due to non-compliance with financial covenants. See Note 14C (1)

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

C. CPI and foreign currency risks

(1) Exposure to CPI and foreign currency risks

	December 31, 2010				
	Unlinked	CPI-linked	Foreign currency or linked thereto (mainly dollar)	Non-monetary balance	Total
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Current assets					
Cash and cash equivalents	339	-	26	-	365
Trade receivables	2,629	34	38	-	2,701
Other receivables	48	52	-	124	224
Other investments, including derivatives	2	2	3	-	7
Inventory	-	-	-	178	178
Assets classified as held for sale	-	-	-	29	29
Current tax assets	3	-	-	-	3
Non-current assets					
Long-term trade and other receivables	949	161	4	-	1,114
Investments and long-term loans, including:					
Derivatives	87	10	30	2	129
Property, plant and equipment	-	-	-	5,610	5,610
Intangible assets	-	-	-	2,248	2,248
Other deferred expenses	-	-	-	292	292
Equity-accounted investments	-	1,351	-	(267)	1,084
Deferred tax assets	-	-	-	254	254
Total assets	4,057	1,610	101	8,470	14,238
Current liabilities					
Loans and borrowings	7	942	-	-	949
Employee benefits – not in the scope of IFRS 7	269	-	-	-	269
Trade payables	887	-	174	-	1,061
Other payables, including derivatives	675	85	10	-	770
Current tax liabilities	-	267	-	-	267
Deferred income	4	-	-	29	33
Provisions	31	216	-	4	251
Non-current liabilities					
Debentures	-	1,967	-	-	1,967
Bank loans	2,670	131	-	-	2,801
Deferred revenue and other provisions	103	-	1	8	112
Deferred tax liabilities	-	-	-	83	83
Employee benefits – not in the scope of IFRS 7	202	56	47	-	305
Total liabilities	4,848	3,664	232	124	8,868
Total exposure in the statement of financial position	(791)	(2,054)	(131)	8,346	5,370
Currency futures transactions					
CPI forward transactions	(390)	390	-	-	-

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

C. CPI and foreign currency risks (contd.)

(1) Exposure to CPI and foreign currency risks (contd.)

	December 31, 2009				
	Unlinked	CPI-linked	Foreign currency or linked thereto (mainly dollar)	Non-monetary balance	Total
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Current assets					
Cash and cash equivalents	549	-	31	-	580
Trade receivables	2,396	30	65	-	2,491
Other receivables	72	5	-	94	171
Other investments, including derivatives	140	12	2	-	154
Inventory	-	-	-	263	263
Assets classified as held for sale	-	-	-	40	40
Non-current assets					
Long-term trade and other receivables	788	94	5	-	887
Long-term investments and loans, including derivatives	83	10	31	6	130
Property, plant and equipment	-	-	-	5,428*	5,428*
Intangible assets	-	-	-	1,885	1,885
Other deferred expenses	-	-	-	301*	301*
Equity-accounted investments	1	1,166	-	52	1,219
Deferred tax assets	-	-	-	392	392
Total assets	4,029	1,317	134	8,461	13,941
Current liabilities					
Loans and borrowings	17	845	-	-	862
Employee benefits – not in the scope of IFRS 7	505	-	-	-	505
Trade payables	833	-	258	-	1,091
Other payables, including derivatives	600	94	3	-	697
Current tax liabilities	-	118	-	-	118
Deferred income	5	-	-	31	36
Provisions	30	338	-	12	380
Non-current liabilities					
Debentures	-	2,716	-	-	2,716
Bank loans	383	175	-	-	558
Deferred revenue and other provisions	60	-	-	16	76
Deferred tax liabilities	-	-	-	70	70
Employee benefits – not in the scope of IFRS 7	188	57	49	-	294
Total liabilities	2,621	4,343	310	129	7,403
Total exposure in the statement of financial position	1,408	(3,026)	(176)	8,332	6,538
Currency futures transactions					
Dollar/shekel forward transactions	(32)	-	32	-	-
CPI forward transactions	(440)	440	-	-	-
Dollar/shekel sale options	-	-	(26)	-	(26)
Dollar/shekel purchase options	-	-	26	-	26
	(472)	440	32	-	-

* Retrospective application by restatement, see Note 2H

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

C. CPI and foreign currency risks (contd.)

(1) Exposure to CPI and foreign currency risks (contd.)

The Group has CPI forward transactions for the CPI:

	December 31, 2010				
	Currency/ linkage receivable	Currency/ linkage payable	Expiry date	Par value (currency)	Fair value
				Millions	NIS millions
Instruments not used for hedging:					
CPI forward contract	CPI	CPI	2011-2012	**390**	**12**

	December 31, 2009				
	Currency/ linkage receivable	Currency/ linkage payable	Expiry date	Par value (currency)	Fair value
				Millions	NIS millions
Instruments not used for accounting hedging:					
Forward exchange contracts	USD	NIS	2010-2011	7	(1)
CPI forward contract	CPI	CPI	2010-2012	440	21
Foreign currency purchase options	USD	NIS	2010	7	-
Foreign currency put options	USD	NIS	2010	7	(1)
					19

Data in NIS for exchange rates and CPI

				Change (%)	Change (%)	Change (%)
	December 31 2010	December 31 2009	December 31 2008	December 31 2010	December 31 2009	December 31 2008
CPI in points (*)	**133.89**	130.42	125.5	**2.66**	3.91	3.8
1 US dollar	**3.549**	3.775	3.802	**(5.99)**	(0.71)	(1.14)
1 euro	**4.738**	5.442	5.297	**(12.94)**	2.73	(6.39)

(*) CPI for the month at average base of 100=1998

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

D. Interest rate risk

(1) Type of interest

The interest rate for the Group's interest-bearing financial instruments at the reporting date is as follows:

	Carrying amount 2010 NIS millions	Carrying amount 2009 NIS millions
Fixed-interest instruments		
Financial assets	**2,551**	2,341
Financial liabilities	**(4,347)**	(3,736)
	(1,796)	(1,395)
Variable-interest instruments		
Financial liabilities	**(1,370)**	(400)

(2) Fair value sensitivity analysis for fixed rate instruments

The Group's assets and liabilities at fixed interest are not measured at fair value through profit or loss, nor does the Group designate derivatives (interest swap contracts) as hedging instruments according to a hedge accounting model of fair value. Accordingly, a change in interest rates at the reporting date will not affect profit or loss.

(3) Sensitivity analysis of cash flow for instruments at variable interest

An increase of 100 basis points in the interest rate at the reporting date would decrease shareholders' equity and profit or loss by approximately NIS 10.28 million (2009-approximately NIS 2.96 million). This analysis assumes that all other variables, especially foreign currency rates, remain stable.

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

E. Fair value

(1) Fair value compared to carrying amounts

The table below shows the differences between the carrying amount and the fair value of groups of financial instruments, where material differences exist among them. The carrying amount of financial assets does not differ significantly from their fair value.

	December 31, 2010		December 31, 2009	
	Carrying amount	Fair value	Carrying amount	Fair value
	NIS millions	NIS millions	NIS millions	NIS millions
Short-term credit	**7**	**7**	-	-
Secured loans from banks and others				
CPI-inked	**180**	**192**	223	235
Unlinked	**2,684**	**2,684**	403	403
Debentures issued to the public				
CPI-inked	**2,249**	**2,387**	2,548	2,707
Debentures issued to financial institutions and others				
CPI-inked	**712**	**760**	1,058	1,079
	5,832	**6,030**	4,232	4,424

The methods used to estimate the fair values of financial instruments are described in Note 4.

(2) Interest rates used to determine fair value

	2010	2009
	%	%
Long-term trade receivables	**5**	5
Loans	**4.5**	3.5
Debentures	**1.3**	3.4

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

E. Fair value (contd.)

(3) Fair value hierarchy

The table below presents an analysis of the financial instruments measured at fair value, using the evaluation method.

The levels are defined as follows:

a. Level 1: Quoted prices (unadjusted) in an active market for identical instruments
b. Level 2: Observable market inputs, direct or indirect, other than Level 1 inputs
c. Level 3: Inputs not based on observable market data

	December 31, 2010			
	Level 1	**Level 2**	**Level 3**	**Total**
	NIS millions	**NIS millions**	**NIS millions**	**NIS millions**
Derivatives not used for hedging				
Forward contracts on CPI		12		12
Forward contracts on copper	**-**	**(10)**	**-**	**(10)**
Available-for-sale financial assets:				
Unmarketable shares	**-**	**-**	**29**	**29**
	-	**2**	**29**	**31**

	December 31, 2009			
	Level 1	**Level 2**	**Level 3**	**Total**
	NIS millions	**NIS millions**	**NIS millions**	**NIS millions**
Financial assets held for trading:				
Monetary fund	141	-	-	141
Derivatives not used for hedging				
Options	-	(1)	-	(1)
Forward contracts	-	20	-	20
Available-for-sale financial assets:				
Unmarketable shares	-	-	31	31
	141	19	31	191

NOTE 32 - FINANCIAL INSTRUMENTS (CONTD.)

E. Fair value (contd.)

(4) Financial instruments measured at fair value on level 3

The table below reconciles the opening and closing balances in respect of financial instruments measured at fair value on level 3 in the fair-value hierarchy:

	2010	2009
	Available-for-sale financial assets	Available-for-sale financial assets
	Non-marketable shares	Non-marketable shares
	NIS millions	NIS millions
Balance as at January 1	**31**	50
Total profits recognized in the statement of income	**-**	23
Acquisitions	**5**	4
Disposal consideration	**(10)**	(45)
Capital reserve	**3**	(1)
Balance as at December 31	**29**	31
Total profits for the year included in the statement of income under financing income	**7**	9

NOTE 33 - SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD. AND BEZEQ INTERNATIONAL LTD.

1. Pelephone Communications Ltd.

A. Statement of financial position

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Current assets	**2,071**	2,102
Non-current assets	**2,821**	2,888
	4,892	4,990
Current liabilities	**1,198**	1,519
Non-current liabilities	**732**	921
Total liabilities	**1,930**	2,440
Equity	**2,962**	2,550
	4,892	4,990

B. Statement of income

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Revenue from services	**4,550**	4,256	4,020
Revenue from terminal equipment sales	**1,182**	1,120	693
Total revenue from services and sales	**5,732**	5,376	4,713
Cost of services and sales	**3,754**	3,592	3,235
Gross profit	**1,978**	1,784	1,478
Selling and marketing expenses	**468**	461	405
General and administrative expenses	**127**	133	140
Operating profit	**1,383**	1,190	933
Financing expenses	**111**	100	115
Financing income	**(100)**	(90)	(117)
Financing expenses (income), net	**11**	10	(2)
Profit before income tax	**1,372**	1,180	935
Income tax	**339**	305	253
Profit for the year	**1,033**	875	682

NOTE 33 - SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. Bezeq International Ltd.

A. Statement of financial position

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Current assets	**447**	547
Non-current assets	**591**	559
	1,038	1,106
Current liabilities	**279**	367
Non-current liabilities	**25**	37
Total liabilities	**304**	404
Equity	**734**	702
	1,038	1,106

B. Statement of income

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Revenue	**1,380**	1,318	1,306
Operating expenses	**822**	777	780
Gross profit	**558**	541	526
Selling and marketing expenses	**192**	175	181
General and administrative expenses	**109**	105	103
Other, net	**(63)**	-	-
Operating profit	**320**	261	242
Financing expenses	**11**	12	8
Financing income	**(6)**	(15)	(7)
Financing expenses (income), net	**5**	(3)	1
Share in earnings of equity-accounted investees	**3**	7	5
Profit before income tax	**318**	271	246
Income tax expense	**65**	71	68
Net profit for the year	**253**	200	178

NOTE 34 – SUBSEQUENT EVENTS

In February 2011, the Company received a letter of undertaking from a bank in Israel for long-term credit amounting to up to NIS 1.5 billion to finance the Company's cash flow requirements. The credit can be used for one year subject to the terms determined by the parties.

DBS SATELLITE SERVICES (1998) LTD.

FINANCIAL STATEMENTS
DECEMBER 31, 2010

Financial Statements as at December 31, 2010

Contents

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Auditors Report for the Shareholders of
D.B.S. Satellite Services (1998) Ltd.

We have audited the accompanying statements of financial position of D.B.S. Satellite Services (1998) Ltd. ("the Company") as at December 31, 2010 and 2009 and the related income statements, the statements of comprehensive income, the statements of changes in equity and the statements of cash flows for each of the three years, the last of which ended December 31, 2010. These financial statements are the responsibility of the Company's Board of Directors and of its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in Israel, including standards prescribed by the Auditors' Regulations (Manner of Auditor's Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management of the Group, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion these financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2010 and 2009, and its results of operations, changes in equity and cash flows for each of the three years, the last of which ended December 31, 2010, in accordance with International Financial Reporting Standards (IFRS) and in accordance with the Securities Regulations (Annual Financial Statements) - 2010.

Without qualifying our opinion, we draw attention to Note 5 with respect to the financial position of the Company. The continuation of the Company's activities depends, inter alia, on its compliance with the stipulations determined for 2011.

Furthermore, we draw attention to Note 21B to the financial statements with respect to a class action filed against the Company with respect to disruptions to the Company's broadcasts. Based on the assessment of the Company's management, which is based on the opinion of its legal counsel, the Company has included an appropriate provision in its financial statements.

Somekh Chaikin
Certified Public Accountants

March 7, 2011

Statement of Financial Position as at December 31

	Note	2010 NIS thousands	2009 NIS thousands
Assets			
Trade receivables	6	**168,847**	160,152
Other receivables	6	**11,150**	11,197*
Total current assets		**179,997**	171,349
Property, plant and equipment, net	7	**675,888**	682,473
Intangible assets, net	8	**82,769**	67,043
Broadcasting rights, net of rights exercised	9	**304,490**	284,766
Total non-current assets		**1,063,147**	1,034,282
Total assets		**1,243,144**	1,205,631

* Reclassified

.

Statement of Financial Position as at December 31

	Note	2010 NIS thousands	2009 NIS thousands
Liabilities			
Borrowings from banks	10	**135,438**	283,698
Current maturities for debentures	14	**56,062**	54,812
Trade payables	11	**355,771**	405,389*
Other payables	12	**164,951**	150,420*
Provisions	13	**89,266**	9,079*
Total current liabilities		**801,488**	903,398
Debentures	14	**1,030,973**	625,741
Loans from institutions	15	**-**	181,729
Bank loans	10	**470,810**	607,036
Loans from shareholders	16	**2,300,387**	1,981,887
Long-term trade payables	17	**54,264**	9,001*
Employee benefits	18	**6,696**	5,599*
Total non-current liabilities		**3,863,130**	3,410,993
Total liabilities		**4,664,618**	4,314,391
Capital deficit			
Share capital		**29**	29
Share premium		**85,557**	85,557
Option warrants		**48,219**	48,219
Capital reserves		**1,537,271**	1,537,271
Capital reserve for share-based payments		**9,391**	6,931
Retained loss		**(5,101,941)**	(4,786,767)
Total capital deficit	22	**(3,421,474)**	(3,108,760)
Total liabilities and capital		**1,243,144**	1,205,631

Authorized to sign on behalf of chairman of the board (See Note 33).	Ron Eilon CEO	Katriel Moriah CFO

* Reclassified

Date of approval of the financial statements: March 7, 2011

The attached notes are an integral part of these financial statements.

Statements of Income for the Year Ended December 31

	Note	2010 NIS thousands	2009 NIS thousands	2008 NIS thousands
Revenue		**1,582,930**	1,530,435	1,512,632
Cost of revenue	23	**1,128,848**	1,042,101	1,091,171
Gross profit		**454,082**	488,334	421,461
Selling and marketing expenses	24	**143,202**	122,312	128,162
General and administrative expenses	25	**132,561**	117,805	116,151
		275,763	240,117	244,313
Operating profit		**178,319**	248,217	177,148
Financing expenses		**181,584**	177,900	229,650
Financing income		**(9,313)**	(8,347)	(51,805)
Shareholders' finance expenses		**318,499**	300,373	262,961
Financing expenses, net	26	**490,770**	469,926	440,806
Loss before income tax		**(312,451)**	(221,709)	(263,658)
Income tax	27	**1,188**	745	1,048
Loss for the period		**(313,639)**	(222,454)	(264,706)
Basic and diluted loss per share (in NIS)		**10,491**	7,441	8,919

The attached notes are an integral part of these financial statements.

Statements of Comprehensive Income for the Year Ended December 31

	Note	2010 NIS thousands	2009 NIS thousands	2008 NIS thousands
Loss for the period		**(313,639)**	(222,454)	(264,706)
Other items of comprehensive income:				
Actuarial gains (losses) from a defined benefit plan	18	**(1,535)**	537	127
Other comprehensive profit (loss) for the year		**(1,535)**	537	127
Total comprehensive loss for the year		**(315,174)**	(221,917)	(264,579)

The attached notes are an integral part of these financial statements.

Statements of Changes in Equity for the Year Ended December 31

	Note	Share capital	Share premium	Option warrants	Capital reserve	Capital reserve for share-based payments	Accrued deficit	Total
		NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance at January 1, 2010		29	85,557	48,219	1,537,271	6,931	(4,786,767)	(3,108,760)
Total comprehensive income for the year								
Loss for the year		-	-	-	-	-	**(313,639)**	**(313,639)**
Other comprehensive loss for the year		-	-	-	-	-	**(1,535)**	**(1,535)**
Total comprehensive loss for the year		-	-	-	-	-	**(315,174)**	**(315,174)**
Transactions with owners recognized directly in equity								
Share-based payments	19	-	-	-	-	**2,460**	-	**2,460**
Balance at December 31, 2010		**29**	**85,557**	**48,219**	**1,537,271**	**9,391**	**(5,101,941)**	**(3,421,474)**
Balance at January 1, 2009		29	85,557	48,219	1,537,271	1,636	(4,564,850)	(2,892,138)
Total comprehensive income for the year								
Loss for year		-	-	-	-	-	(222,454)	(222,454)
Comprehensive income for the year		-	-	-	-	-	537	537
Total comprehensive loss for the year		-	-	-	-	-	(221,917)	(221,917)
Transactions with owners recognized directly in equity								
Share-based payments	19	-	-	-	-	5,295	-	5,295
Balance at December 31, 2009		29	85,557	48,219	1,537,271	6,931	(4,786,767)	(3,108,760)

The attached notes are an integral part of these financial statements.

Statements of Changes in Equity for the Year Ended December 31

	Note	Share capital	Share premium	Option warrants	Capital reserve	Capital reserve for share-based payments	Accrued deficit	Total
		NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance at January 1, 2008		29	85,557	48,219	1,537,271	-	(4,300,271)	(2,629,195)
Total comprehensive income for the year		-	-	-	-	-		
Loss for year							(264,706)	(264,706)
Comprehensive income for the year		-	-	-	-	-	127	127
Total comprehensive loss for the year		-	-	-	-	-	(264,579)	(264,579)
Transactions with owners recognized directly in equity								
Share-based payments	19	-	-	-	-	1,636	-	1,636
Balance at December 31, 2008		29	85,557	48,219	1,537,271	1,636	(4,564,850)	(2,892,138)

The attached notes are an integral part of these financial statements.

Statements of Cash Flows for the Year Ended December 31

	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Cash flows from operating activities			
Loss for the period	**(313,639)**	(222,454)	(264,706)
Adjustments:			
Depreciation and amortization	**284,732**	234,203	249,880
Financing expenses, net	**465,562**	455,232	426,258
Proceeds from sale of property, plant and equipment	**(35)**	(236)	(124)
Share-based payments	**2,460**	5,295	1,636
Income tax expenses	**1,188**	745	1,048
Change in trade receivables	**(8,695)**	(7,277)	(7,352)
Change in other receivables	**(2,896)**	84	5
Change in trade payables	**(2,731)**	(8,391)*	(69,189)*
Change in other payables and provisions	**83,659**	(14,898)*	21,358*
Change in broadcasting rights, net of rights exercised	**(19,724)**	(31,433)	(10,585)
Change in employee benefits	**(438)**	(82)	3,871
	803,082	633,242	616,806
Income tax paid	**(1,188)**	(1,060)	(5,073)
Net cash from operating activities	**488,255**	409,728	347,027
Cash flows from investing activities			
Repayment of short-term deposits	**3,259**	-	-
Interest received	**-**	-	76
Proceeds from sale of property, plant and equipment	**1,589**	949	-
Purchase of property, plant and equipment	**(226,728)**	(214,368)	(198,208)
Acquisition of intangible assets	**(14,897)**	(9,262)	(12,643)
Payments for subscriber acquisition	**(36,756)**	(37,931)	(26,690)
Net cash used for investing activities	**(273,533)**	(260,612)	(237,465)

* Reclassified

The attached notes are an integral part of these financial statements.

Statements of Cash Flows for the Year Ended December 31 (contd.)

	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Cash flow from finance activities			
Repayment of loans from institutions	**(115,731)**	-	-
Bank loans received	**255,000**	-	-
Repayment of bank loans	**(580,718)**	-	-
Repayment of debentures	**(55,020)**	-	-
Short-term bank credit, net	**41,232**	13,532	(50,471)
Interest paid	**(203,444)**	(162,648)	(59,091)
Issue of debentures, net	**443,959**	-	-
Net cash used for financing activities	**(214,722)**	(149,116)	(109,562)
Increase in cash and cash equivalents	**-**	-	-
Cash and cash equivalents at beginning of year	**-**	-	-
Cash and cash equivalents at end of year	**-**	-	-

The attached notes are an integral part of these financial statements.

NOTE 1 – GENERAL

A. Reporting entity

DBS Satellite Services (1998) Ltd. ("the Company") was incorporated in Israel on December 2, 1998 and its head office is at 6, Hayozma St., Kfar Saba, Israel.
In January 1999, the Company received a license from the Ministry of Communications for satellite television broadcasts ("the License"). The License is valid until January 2017 and may be extended for further six years each under certain conditions. The Company's operations are subject to, *inter alia,* the Communications (Telecommunications and Broadcasts) Law 5742-1982 ("the Communications Law") and its subsequent regulations and rules, and to the terms of the License.

Pursuant to the license of Bezeq The Israel Telecommunication Corporation Limited ("Bezeq"), Bezeq is required to maintain full structural separation between it and its subsidiaries, and between it and the Company. In May and June 2010, the licenses of Bezeq and the Company respectively were amended in a manner permitting them, under certain conditions to market joint service packages.

In August 2009, the Supreme Court accepted the Antitrust Commissioner's appeal of the ruling of the Antitrust Tribunal approving the merger (as defined in the Antitrust Law, 5748-1988) between the Company and Bezeq by exercising the options held by Bezeq in the Company, subject to certain conditions, and ruled against the merger**.**

B. Definitions

In these financial statements -

(1) International Financial Reporting Standards ("IFRS"): Standards and interpretations adopted by the Israel Accounting Standards Board (IASB). These standards and interpretations include International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) and the interpretations of these standards defined by the International Financial Reporting Interpretations Committee (IFRIC) or interpretations defined by the Standing Interpretations Committee (SIC)

(2) The Company: DBS Satellite Services (1998) Ltd.

(3) Related party: As defined in IAS 24, *Related Party Disclosures*

(4) Interested parties: As defined in paragraph (1) of the definition of an "interested party" in section 1 of the Securities Law, 5728-1968

(5) CPI: The consumer price index as published by the Central Bureau of Statistics

NOTE 2 - BASIS OF PREPARATION

A. Statement of compliance

These financial statements have been prepared in conformity with International Financial Reporting Standards (IFRS) and with the provisions of the Israeli Securities Regulations (Annual Financial Statements), 2010
The Company adopted IFRS for the first time in 2006, with the date of transition to IFRS being January 1, 2005 ("the date of transition").

The financial statements were approved by the Board of Directors on March 7, 2011.

NOTE 2 - BASIS OF PREPARATION (CONTD.)

B. Functional and presentation currency

These financial statements are presented in NIS, which is the Company's functional currency, and have been rounded to the nearest thousand. The NIS is the currency that represents the principal economic environment in which the Company operates.

C. Basis of measurement

The consolidated financial statements have been prepared on the historical cost basis except for the following assets and liabilities: derivative financial instruments.
The amount recognized as a defined benefit obligation is the current value of the defined benefit obligation at the end of the reporting period less costs for any past service that has as yet not been recognized and less the fair value at the end of the reporting period of plan assets that will directly serve to settle the obligation.
The value of non-monetary assets and equity items that were measured on the historical cost basis was adjusted to changes in the CPI until December 31, 2003, since until that date Israel was considered a hyperinflationary economy.

D. Use of estimates and judgments

The preparation of the financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

The preparation of accounting estimates used in the preparation of the Company's financial statements requires management to make assumptions regarding circumstances and events that involve considerable uncertainty. Management of the Company prepares the estimates on the basis of past experience, various facts, external circumstances, and reasonable assumptions according to the pertinent circumstances of each estimate.
Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

Information about critical estimates made by management while implementing accounting policies and which have the most significant effect on the financial statements is included in the following notes:

- **Contingent liabilities**: When assessing the possible outcomes of legal claims that were filed against the Company, the Company relied on the opinions of its legal counsel. These opinions are based on the best of their professional judgment, and take into consideration the current stage of the proceedings and the legal experience accumulated with respect to the various matters. As the outcomes of the claims are determined by the courts, these outcomes could differ from the assessments.

- **Impairment of assets**: The Company examines, at each reporting date, whether there have been any events or changes in circumstances which would indicate impairment of one or more non-monetary assets. When there are indications of impairment, the Company assesses whether the carrying amount of the investment in the asset can be recovered from the future discounted cash flows anticipated to be derived from the asset, and if necessary, it records an impairment provision up to the amount of the recoverable value. The estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. The estimates regarding cash flows are based on past experience with respect to this asset or similar assets, and on the best possible assessments of the Company regarding the economic conditions that will exist during the remaining useful life of the asset.

NOTE 2 - BASIS OF PREPARATION (CONTD.)

D. Use of estimates and judgments (contd.)

- **Useful life**: The Company's items of fixed assets, intangible assets and broadcasting rights are amortized using the straight line method over the estimated useful life of the asset. The estimated useful life of these items is based on their estimated technical life and the condition of the equipment. Changes in these factors, which affect the estimated useful life of the asset, have a material impact on the Company's financial position and the results of its operations. The estimated useful life of the fixed assets and intangible assets are presented in Note 3(C) and Note 3(D) below.

E. Changes in accounting policy

(1) Presentation of the statement of changes in equity
As from January 1, 2010 the Company has early implemented the revision to IAS 1, *Presentation of Financial Statements*, which was issued in the framework of *Improvements to IFRS 2010.* According to the revision, the Company presents in the statement of changes in equity, for each component of equity, a reconciliation between the carrying amount at the beginning of the period and the carrying amount at its end, and provides separate disclosure for each change resulting from profit or loss, other comprehensive income, and transactions with the owners in their capacity as owners.

(2) Employee benefits
Commencing from January 1, 2009, the Company applies IAS 19 – *Employee Benefits*, revised ("the Amendment"), in accordance with Improvements to IFRS for 2008. The Amendment addresses the definition of "short-term employee benefits" and "other long-term employee benefits" to refer to when the liabilities are due to be settled. Accordingly, certain benefits are classified as short-term benefits. The Amendment is applied retrospectively. The effect of the Amendment on the financial statements was immaterial.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES

The financial statements have been prepared on the basis of IFRS and their related interpretations,

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

A. Foreign currency transactions

Transactions in foreign currency are translated into the functional currency of the Company at the exchange rate on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies on the reporting date are retranslated to the functional currency at the exchange rate at that date.

B. Broadcasting rights

Broadcasting rights are stated at cost, net of rights exercised.
The cost of broadcasting rights includes the amounts paid to the content provider. Broadcasting rights are amortized in accordance with the terms of the purchase agreement, based on actual broadcasts from the total number of expected broadcasts or permitted under the agreement (the part that has not been unamortized by the end of the agreement is amortized in full upon termination of the agreement), or according to the period of the rights agreement. The net adjustment of the broadcasting rights is presented as an adjustment of earnings as part of ongoing operations in the statement of cash flows.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Property, plant and equipment

(1) Recognition and measurement
Items of property, plant and equipment are measured at cost less accumulated depreciation and accumulated impairment losses.

The cost includes expenditure that is directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labor, any other costs directly attributable to bringing the assets to a working condition for their intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalized as part of that equipment.

When major parts of a fixed asset item (including costs of major periodic inspections) have different useful lives, they are accounted for as separate items (major components) of fixed assets.

(2) Subsequent expenditure
The cost of replacing part of an item of property, plant and equipment is recognized when that cost is incurred if it is probable that the future economic benefits embodied in the item will flow to the Company and the cost of the item can be reliably measured. The carrying amount of the replaced part is derecognized. Ongoing maintenance costs are recognized in the statement of income as incurred.

(3) Depreciation
Depreciation is recognized in profit or loss on a straight-line basis over the estimated useful lives of each part of a fixed asset item.

	Years
Broadcasting and receiving equipment	6.67
Installation costs *	1-3,15
Digital satellite decoders	4,6,8
Office furniture and equipment	6.67-14.2
Computers	3

* The costs of installation in apartments are depreciated over the term of the contract with the subscribers.

Leasehold improvements are depreciated over the shorter of the rental period or the expected useful life of the improvements.

D. Intangible assets

(1) Acquisition of subscribers
The Company discounts the direct sale commissions paid to marketers and salespersons for sales and services to subscribers who have signed long-term commitments with the Company and recognizes these costs as an intangible asset. When the subscriber terminates the agreement period, the balance of the asset is amortized immediately.

(2) **Software**
Stand alone software that adds functionality to the hardware is classified as an intangible asset.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

D. Intangible assets (contd.)

(3) Research and development

Research activities involve a plan for the production of new or substantially improved products or processes. Development expenditure is capitalized only if development costs can be measured reliably, the product or process is technically and commercially feasible, future economic benefits are probable and the Company intends to and has sufficient resources to complete development and to use or sell the asset. The costs recognized as an intangible asset include the cost of materials, direct labor and overhead costs that are directly attributable to preparing the asset for its intended use. Other development expenditure is recognized in profit or loss as incurred.

Capitalized development expenditure is measured at cost less accumulated amortization and accumulated impairment losses.

(4) Amortization

Amortization of intangible assets is recognized in the statement of income on a straight-line basis over the estimated useful life of the intangible assets, from the date on which the assets are available for use.

Estimated useful lives for the current and comparative periods are as follows:

	Years
Software	3,5
Subscriber acquisition costs*	1-3
Capitalized development costs	1-5

* Pursuant to the terms and conditions of contracts with the subscribers.

E. Financial instruments

(1) Non-derivative financial instruments

Non-derivative financial instruments comprise debt instruments, trade and other receivables, loans and borrowings, and trade and other payables.

Non-derivative financial instruments are recognized initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition, non-derivative financial instruments are measured as described below.

A financial instrument is recognized when the Company accepts the contractual terms of the instrument. Financial instruments are derecognized when the contractual rights of the Company to the cash flows from the asset expire, or the Company transfers to others the financial assets, without retaining control over the asset, or substantially transfers all the risks and rewards arising from the asset. Regular way purchases and sales of financial assets are recognized on the trade date, meaning on the date the Company undertook to purchase or sell the asset. Financial liabilities are derecognized when the obligation of the Company, as specified in the agreement, expires or when it is discharged or cancelled.

(2) Non-derivative financial liabilities

Non-derivative financial instruments are recognized initially on the date that they are created. All other financial liabilities (including financial liabilities recognized at fair value through profit or loss) are recognized initially on the trade date at which the Company becomes a party to the contractual provisions of the instrument.
Financial liabilities are derecognized when the obligation of the Group, as specified in the agreement, expires or when it is discharged or cancelled.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

E. Financial instruments (contd.)

(2) Non-derivative financial liabilities (contd.)
Financial liabilities (except for financial liabilities recognized at fair value through profit or loss), are recognized initially at fair value plus all the attributable transaction costs.
Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method.

An exchange of debt instruments having substantially different terms, between an existing borrower and lender are accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability at fair value. Furthermore, a substantial modification of the terms of the existing financial liability or part of it, is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The terms are substantially different if the discounted present value of the cash flows according to the new terms, including any commissions paid, less any commissions received and discounted using the original effective interest rate, is different by at least ten percent from the discounted present value of the remaining cash flows of the original financial liability.
In addition to the aforesaid quantitative criterion, the Company examines, inter alia, whether there have been changes also in various economic parameters inherent in the exchanged debt instruments, therefore exchanges of CPI-linked debt instruments with unlinked instruments are considered exchanges with substantially different terms even if they do not meet the aforementioned quantitative criterion.
Non-derivative financial liabilities include bank overdrafts, loans and borrowings from banks and others, finance lease liabilities, redeemable preferred shares and trade and other payables.

Financial assets and liabilities are offset and the net amount presented in the statement of financial position when the Company currently has a legal right to offset the amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

(3) Derivative financial instruments
The Company holds derivative financial instruments to hedge its foreign currency risk exposure. The financial instruments comprise mainly forward transactions.
Derivative financial instruments are recognized initially at fair value; attributable transaction costs are recognized in profit or loss as incurred. Subsequent to initial recognition, derivatives are measured at fair value. Hedge accounting is not applied to derivative instruments that economically hedge financial assets and liabilities denominated in foreign currencies. Changes in the fair value of these derivatives are recognized in profit or loss, as part of the profits or losses from foreign currency.

(4) CPI-linked assets and liabilities that are not measured at fair value
The value of CPI-linked financial assets and liabilities, which are not measured at fair value, is remeasured every period in accordance with the actual increase in the CPI.

F. Impairment

(1) Financial assets
A financial asset is tested for impairment when objective evidence indicates that one or more events had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortized cost is calculated as the difference between its carrying amount, and the present value of the estimated future cash flows discounted at the original effective interest rate. All impairment losses are recognized in profit or loss.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

F. Impairment (contd.)

(2) Non-financial assets

The carrying amounts of the Company's non-financial assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated. The Company estimates the recoverable amount once a year, if there are indications of impairment.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.
For the purpose of impairment testing, the assets are grouped together into the smallest group of assets that generates cash from continuing that are largely independent of other assets or groups of assets ("cash-generating unit").

An impairment loss is recognized if the carrying amount of an asset or its cash-generating unit exceeds its estimated recoverable amount. Impairment losses are recognized in profit or loss.

G. Employee benefits

(1) Post-employment benefits

The Company has a number of post-employment benefit plans. The plans are usually financed by deposits with insurance companies and they are classified as defined contribution plans and defined benefit plans.

(A) Defined contribution plans

The Company's obligations for contributions to defined contribution pension plans are recognized as an employee benefit expense in the statement of income in the periods during which services are rendered by employees.

(B) Defined benefit plans

The Company's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is presented at its present value less the fair value of any plan assets. The discount rate is the yield at the reporting date on government bonds denominated in the same currency that have maturity dates approximating the terms of the Company's obligations. The calculation is performed by a qualified actuary using the projected unit credit method.

When the calculation results in an asset for the Company, an asset is recognized up to the net present value of economic benefits available in the form of a refund from the plan or a reduction in future contributions to the plan. An economic benefit in the form of refunds or reduction in future payments will be considered to be available when it can be exercised during the life of the plan or after settlement of the obligation.

When the minimum contribution requirement includes an obligation to pay additional amounts for services that were provided in the past, the Company recognizes an additional obligation (increases the net liability or decreases the net asset), if such amounts are not available as an economic benefit in the form of a refund from the plan or the reduction of future contributions.

When the benefits of a plan are improved, the portion of the increased benefit relating to past service by employees is recognized as an expense in profit or loss on a straight-line basis over the average period until the benefits vest. To the extent that the benefits vest immediately, the expense is recognized immediately in profit or loss.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

G. Employee benefits (contd.)

(1) Post-employment benefits (contd.)

(B) Defined benefit plans (contd.)
The Company recognizes immediately, directly in retained earnings through other comprehensive income, all actuarial gains and losses arising from defined benefit plans.

The Company offsets an asset relating to one benefit plan from the liability relating to another benefit plan only when there is a legally enforceable right to use the surplus of one plan to settle the obligation in respect of the other plan, and there is intent to settle the obligation on a net basis or to simultaneously realize the surplus of one plan and settle the obligation in the other plan.

(2) Short-term employee benefits
Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided or upon the actual absence of the employee when the benefit is not accumulated (such as maternity leave).
A liability is recognized for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Company has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably. In the statement of financial position the employee benefits are classified as current benefits or as non-current benefits according to the time the liability is due to be settled.

(3) Other long-term employee benefits
The Company's net obligation in respect of long-term employee benefits other than post-employment plans is the amount of future benefit that employees have earned in return for their service in the current and prior periods. The benefit is discounted to determine its present value. The discount rate is the yield at the reporting date on government bonds denominated in the same currency, that have maturity dates approximating the terms of the Company's obligations. The calculation is performed using the projected unit credit method. Any actuarial gains or losses are recognized in the statement of income in the period in which they arise.

(4) Share-based payments
The grant date fair value of share-based payment awards granted to employees is recognized as a salary expense, with a corresponding increase in equity, over the period that the employees become unconditionally entitled to the awards. The amount recognized as an expense in respect of share-based payment awards that are conditional upon meeting service and non-market performance conditions, is adjusted to reflect the number of awards that are expected to vest.

Share-based payment arrangements in which the parent company grants to the employees of the Company rights to its equity instruments are accounted for by the Company as equity-settled share-based payment transactions, meaning that the fair value of the grant is recognized directly in equity, as set out above.

H. Provisions

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation.

(1) Onerous contracts
A provision for onerous contracts is recognized when the expected benefits to be derived by the Company from a contract are lower than the unavoidable cost of meeting its obligations under the contract. The provision is measured at the present value of the lower of the expected cost of terminating the contract and the expected net cost of continuing with the contract.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

H. Provisions (contd.)

(2) Legal claims
A provision for claims is recognized if, as a result of a past event, the Company has a present legal or constructive obligation and it is more likely than not that an outflow of economic benefits will be required to settle the obligation and the amount of obligation can be estimated reliably.

I. Revenue

(1) Revenue from services rendered is recognized in the statement of income proportionately over the term of the agreement or on providing the service.

(2) Revenue from rental of digital satellite decoders are attributed proportionately over the term of the agreement.

(3) The Company charges a deposit for the digital satellite decoders rented by its customers. The customers are entitled to receive a proportional refund of the deposit on termination of the agreement, according to the terms in the agreement. The revenue from deposit deductions is attributed to the statement of income, according to the terms of the agreements with the customers.

(4) Commissions: When the Company acts in the capacity of an agent rather than as the principal in a transaction, the revenue recognized is the net amount of commission made by the Company.

J. Income tax expenses

Income tax expense comprises current and deferred tax. Current and deferred taxes are recognized in the statement of income except to the extent that it relates to a business combination, or are recognized directly in equity or in other comprehensive income to the extent they relate to items recognized directly in equity or in other comprehensive income.
Current tax is the expected tax payable (or receivable) on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date.

K. Operating lease

The Company classifies lease agreements, under which the lessor substantially assumes all risks and rewards of ownership, as an operating lease. Payments made under operating leases are recognized in the statements of income on a straight line basis over the term of the lease.

L. Loss per share

Basic loss per share is calculated by dividing the loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the year.

M. Financing income and expenses

Financing income comprises interest income on funds invested, foreign currency gains and gains on derivative instruments that are recognized in the statement of income. Interest income is recognized as accrued using the effective interest method.

Financing expenses comprise interest expense on borrowings, impairment losses of financial assets and losses on derivative instruments recognized in the statement of income. All borrowing costs are recognized in profit or loss using the effective interest method.

Foreign currency gains and losses are reported on a net basis as either financing income or financing expenses depending on whether foreign currency movements are in a net gain or net loss position.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

N. Transactions with a controlling shareholder

Assets and liabilities included in a transaction with a controlling shareholder are measured at fair value on the date of the transaction.

As this is a capital transaction, the differences between the fair value and the proceeds from the transaction are attributed to equity.

O. New standards and interpretations not yet adopted

In the *Improvements to IFRSs* 2010, in May 2010 the IASB published and approved 11 amendments to IFRS and to one interpretation on a wide range of accounting issues. Most of the amendments apply to periods beginning on or after January 1, 2011 and permit early adoption, subject to the specific conditions of each amendment.

Presented hereunder are the amendments that may be relevant to the Company and are expected to have an effect on the financial statements:

- Amendment to IAS 34 *Interim Financial Reporting* – Significant events and transactions ("the Amendment") – The Amendment expanded the list of events and transactions that require disclosure in interim financial statements, such as the recognition of a loss from the impairment of financial assets and changes in the classification of assets as a result of changes in their purpose or use. In addition, the materiality threshold was removed from the minimum disclosure requirements included in the Standard before its amendment. The Amendment is effective for annual periods beginning on or after January 1, 2011.

- Amendment to IAS 7 *Financial Instruments: Disclosures – Clarification of Disclosures* ("the Amendment") – The Amendment requires adding an explicit declaration that the interaction between the qualitative and quantitative disclosures enables the users of the financial statements to better assess the company's exposure to risks arising from financial instruments. Furthermore, the clause stating that quantitative disclosures are not required when the risk is immaterial was removed and certain disclosure requirements regarding credit risk were amended while others were removed. The Amendment is effective for annual periods beginning on or after January 1, 2011. Early implementation is permitted, with disclosure.

- IFRS 9 (2010), *Financial Instruments* ("the Standard"). This Standard is one of the stages in a comprehensive project to replace IAS 39 – *Financial Instruments*: *Recognition and Measurement* ("IAS 39") and it replaces the requirements included in IAS 39 regarding the classification and measurement of financial assets and financial liabilities.

  In accordance with the Standard, there are two principal categories for measuring financial assets: amortized cost and fair value. The basis for classification for debt instruments is based on the entity's business model for managing financial assets and the contractual cash flow characteristics of the financial asset. In accordance with the Standard, an investment in a debt instrument will be measured at amortized cost if the objective of the entity's business model is to hold assets in order to collect contractual cash flows and the contractual terms give rise, on specific dates, to cash flows that are solely payments of principal and interest. All other debt assets are measured at fair value through profit or loss. Furthermore, embedded derivatives are no longer separated from hybrid contracts that have a financial asset host. Instead, the entire hybrid contract is assessed for classification using the principles above. In addition, investments in equity instruments are measured at fair value with changes in fair value being recognized in profit or loss. Nevertheless, the Standard allows an entity on the initial recognition of an equity instrument not held for trading to elect irrevocably to present fair value changes in the equity instrument in other comprehensive income where no amount so recognized is ever classified to profit or loss at a later date.

NOTE 3 - SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

O. New standards and interpretations not yet adopted (contd.)

Dividends on equity instruments where revaluations are measured through other comprehensive income are recognized in profit or loss unless they clearly constitute a return on an initial investment.

The Standard generally preserves the instructions regarding classification and measurement of financial liabilities that are provided in IAS 39. Nevertheless, unlike IAS 39, IFRS 9 (2010) requires as a rule that the amount of change in the fair value of financial liabilities designated at fair value through profit or loss, other than loan grant commitments and financial guarantee contracts, attributable to changes in the credit risk of the liability be presented in other comprehensive income, with the remaining amount being included in profit or loss. However, if this requirement aggravates an accounting mismatch in profit or loss, then the whole fair value change is presented in profit or loss. Amounts thus recognized in other comprehensive income may never be reclassified to profit or loss at a later date. The new standard also eliminates the exception that allowed measuring at cost derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured. Such derivatives are to be measured at fair value.

The Standard is effective for annual periods beginning on or after January 1, 2013, but may be applied earlier, subject to providing disclosure and at the same time adopting other IFRS amendments as specified in the Standard. The Standard is to be applied retrospectively other than in a number of exceptions as indicated in the transitional provisions included in the Standard. In particular, if an entity adopts the Standard for reporting periods beginning before January 1, 2012 it is not required to restate prior periods.

The Company has not yet commenced examining the effects of adopting the Standard on the financial statements.

- IAS 24 (2009) *Related Party Disclosures* (“the Standard”). The new standard includes changes in the definition of a related party and changes with respect to disclosures required by entities related to government. The Standard is to be applied retrospectively for annual periods beginning on or after January 1, 2011. The Company is in the process of reassessing its relationships with related parties for the purpose of examining the effects of adopting the Standard on its financial statements.

NOTE 4 – DETERMINATION OF FAIR VALUE

A number of the Company’s accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and / or disclosure purposes based on the following methods. Further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

A. Derivatives

The fair value of forward exchange contracts is based on their quoted price, if available.

B. Non-derivative financial liabilities

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date.

NOTE 4 – DETERMINATION OF FAIR VALUE (CONTD.)

C. Share-based payment transactions

The fair value of employee share options for employees and of share appreciation rights is measured using the Black-Scholes formula. The assumptions of the model include the share price on the date of measurement, the exercise price of the instrument, expected volatility (based on the weighted average of historical volatility of the Company's shares, over the expected term of the options, and adjusted for changes expected due to publicly available information), expected term of the instruments (based on past experience and the general behavior of the option-holders), expected dividends, and the risk-free interest rate (based on government bonds). Service and non-market performance conditions attached to the transactions are not taken into account in determining fair value.

NOTE 5 – THE FINANCIAL POSITION OF THE COMPANY

A. Since the beginning of its operations, the Company has accumulated substantial losses. The Company's losses for 2010 and 2009 amounted to NIS 314 million and NIS 222 million, respectively. As a result of these losses, the Company's capital deficit and working capital deficit at December 31, 2010 amounted to NIS 3,421 million and NIS 621 million, respectively.

B. 1. In March 2010, an amendment to the Company's bank financing agreement was signed and entered into effect ("the Amendment Agreement"). Pursuant to the Amendment Agreement, another Israeli bank ("the Joining Bank") joined the present syndicate of banks ("the Present Banks"). The Joining Bank provided the Company with its proportionate share of the Company's ongoing credit facilities and also provided the Company with long-term credit of NIS 255 million, most of which was used for its addition (in its proportionate share) to the Company's long-term credit facilities for repayment and early repayment of the Company's debts to the Present Banks. The balance of NIS 46 million was used for the Company's ongoing requirements.

Pursuant to the Amendment Agreement, the Company created a floating lien in favor of the Joining Bank, similar to the existing liens registered in favor of the Present Banks. The Joining Bank was also included in the fixed lien in favor of the Present Banks. The Company's shareholders also signed the amendments to bonds, mortgage deeds and letter of guarantee, as applicable, which they had previously signed in favor of the Present Banks, for the addition of the Joining Bank. Under the Amendment Agreement, the term of the bank loan repayment (both the long-term loans as well as the ongoing facilities) was extended until the end of 2015.

In November 2010, another amendment to the financing agreement took effect. According to the amendment, the Company is required to comply with the debt coverage ratio (based on the ratio between the Company's cash balance and cash flow over the past 12 months and the principal and interest payments over the coming 12 months) and the maximum and minimum supplier credit covenant (after the amendment to the covenants in November 2010). These covenants replace the previous financial covenants that were applicable to the Company. The Company's compliance with these covenants is measured quarterly, and failure to comply with these covenants, subject to extensions stipulated in the Financing Agreement, grants banks the right to demand early repayment of the loans. According to the finance mechanism stipulated in the amendment, if the Company's debentures (Series B) are downgraded below ilBBB (or its equivalent, whichever is lower), the annual interest paid to the banks will increase by 0.25% in respect of each notch on the rating scale, as long as the downgrade is in effect, subject to the terms set out in the financing agreement.

NOTE 5 – THE FINANCIAL POSITION OF THE COMPANY (CONTD.)

B. (contd.)

2. During the year, the Company's credit rating was upgraded from ilBBB- to ilA-, among other reasons, in view of the expected improvement in the Company's liquidity in the short term following the issue of debentures (Series B) and in view of the amendment to the financing agreement that included spacing of the financial covenants with which the Company is required to comply.

3. At December 31, 2010, the Company is in compliance with the financial covenants stipulated in the financing agreements and the debentures.

4. The Company's management believes that the financial resources at its disposal will be sufficient for the Company's operations for the coming year, based on the cash flow forecast approved by the Company's board of directors. If additional resources are required to meet its operational requirements for the coming year, the Company will adapt its operations to preclude the need for additional resources beyond those available to it.

   In recent years, the Company has been required to raise external financing needed inter alia, in order to expand its investments. At the reporting date, any significant increase in the Company's investments will require an expansion of the financing sources at its disposal.

NOTE 6 – TRADE AND OTHER RECEIVABLES

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Trade receivables (1)		
Outstanding debts	**48,192**	46,143
Credit companies	**128,355**	123,022
Less provision for doubtful debts	**(7,700)**	(9,013)
	168,847	160,152
Other receivables (1)		
Prepaid expenses	**3,156**	1,520
Pledged deposits	**77**	3,020*
Others	**7,917**	6,657
* Reclassified	**11,150**	11,197
(1) Including trade and other receivables that are related and interested parties	**77**	52

For further information about related and interested parties, see Note 31 – Related and interested Parties. For the Company's exposure to currency and liquidity risks, see Note 31 – Financial Instruments.

NOTE 7 – PROPERTY, PLANT AND EQUIPMENT, NET

A. Composition

	Broadcasting and reception equipment	Discounted installation costs	Digital satellite decoders	Office furniture and equipment (including computers)	Leasehold improvements	Total
	NIS thousands					
Cost						
Balance at January 1, 2009	210,437	1,405,463	1,409,214	75,324	38,142	3,138,580
Additions during the year	22,045	76,964	103,588	10,335	3,144	216,076
Disposals during the year	-	(5,608)	(1,793)	(1,526)	-	(8,927)
Balance at December 31, 2009	232,482	1,476,819	1,511,009	84,133	41,286	3,345,729
Additions during the year	**4,641**	**99,617**	**115,829**	**10,658**	**4,358**	**235,103**
Disposals during the year	**-**	**(3,741)**	**(638)**	**(149)**	**-**	**(4,528)**
Balance at December 31, 2010	**237,123**	**1,572,695**	**1,626,200**	**94,642**	**45,644**	**3,576,304**
Accumulated depreciation						
Balance at January 1, 2009	166,653	1,142,319	1,086,557	44,219	27,169	2,466,917
Additions during the year	16,415	67,532	106,200	10,841	3,111	204,099
Disposals during the year	-	(5,608)	(636)	(1,516)	-	(7,760)
Balance at December 31, 2009	183,068	1,204,243	1,192,121	53,544	30,280	2,663,256
Additions during the year	**15,219**	**102,413**	**109,919**	**11,360**	**2,204**	**241,115**
Disposals during the year	**-**	**(3,741)**	**(95)**	**(119)**	**-**	**(3,955)**
Balance at December 31, 2010	**198,287**	**1,302,915**	**1,301,945**	**64,785**	**32,484**	**2,900,416**
Carrying amount						
At January 1, 2009	43,784	263,144	322,657	31,105	10,973	671,663
At January 1, 2010	49,414	272,576	318,888	30,589	11,006	682,473
At December 31, 2010	**38,836**	**269,780**	**324,255**	**29,857**	**13,160**	**675,888**

* Reclassified

B. Collateral

To secure its collateral and liabilities, the Company created liens on all its assets, including share capital (subject to the provisions of the Communications Law).

C. Credit acquisitions of fixed assets

In the year ended December 31, 2010, credit for fixed asset acquisitions increased by NIS 10.191 million.

NOTE 8 – INTANGIBLE ASSETS, NET

	Costs of acquisition of subscribers	Software licenses	Total
		NIS thousands	
Cost			
Balance at January 1, 2009	189,318	132,380	321,698
Additions during the year	33,812	20,365	54,177
Balance as at December 31, 2009	223,130	152,745	375,875
Additions during the year	**32,440**	**27,884**	**60,324**
Disposals during the year	**(1,816)**	**-**	**(1,816)**
Balance on December 31, 2010	**253,754**	**180,629**	**434,383**
Accumulated depreciation			
Balance at January 1, 2009	165,705	113,023	278,728
Additions during the year	21,461	8,643	30,104
Balance as at December 31, 2009	**187,166**	**121,666**	**308,832**
Additions during the year	**33,105**	**10,512**	**43,617**
Disposals during the year	**(835)**	**-**	**(835)**
Balance at December 31, 2010	**219,436**	**132,178**	**351,614**
Carrying amount			
At January 1, 2009	23,613	19,357	42,970
At January 1, 2010	35,964	31,079	67,043
At December 31, 2010	**34,318**	**48,451**	**82,769**

In the year ended December 31, 2010, credit for intangible asset acquisitions increased by NIS 6.855 million.

NOTE 9 –BROADCASTING RIGHTS, NET OF RIGHTS EXERCISED

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Cost	**600,385**	511,027
Less - rights exercised	**295,895**	226,261
	304,490	284,766

NOTE 10 - BANK CREDIT

This Note includes information of the contractual conditions of the Company's interest-bearing bank loans and borrowings.
Additional information about the Company's exposure to interest, currency and liquidity risks appears in Note 30.
With respect to collateral and restrictions pertaining to credit and to financial covenants, see Note 28.

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Short-term credit	**85,735**	44,504
Current maturities of bank loans	**49,703**	239,194
	135,438	283,698

Details of the loans:

On December 31, 2010, the Company switched the loan tracks to fixed interest loans bearing interest at an average rate of 6.63% for three years and variable interest loans bearing interest at an average rate of prime + 1.8% for one year.
The loans are repayable according to the settlement schedules set out in the table below. The Company may change the loan track according to the terms of the financing agreement.

The loans are to be settled in the forthcoming years based on the following settlement schedules:

	December 31, 2010
	NIS thousands
2011	49,703
2012	81,703
2013	129,702
2014	129,702
2015	129,702
	520,512

For information about liens, see Note 28.

For information about the amendment to the financing agreement, see Note 5B above.

NOTE 11 – TRADE PAYABLES

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Open accounts	**290,516**	292,411*
Notes and checks for repayment	**65,255**	112,978
	355,771	405,389
Of which - related and interested parties	**19,400**	86,242

For further information about suppliers that are related and interested parties, see Note 31 – Related and interested Parties.
For the Company's exposure to currency and liquidity risks for part of the trade balances, see Note 31 – Financial Instruments

NOTE 12 – OTHER PAYABLES

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Employees and institutions with respect to wages	**27,050**	26,005
Provisions for leave and convalescence pay	**11,423**	10,161
Interest payable for debentures	**30,282**	28,225
Deposits from customers	**5,631**	8,027*
Institutions	**41,540**	39,835
Prepaid income	**22,469**	17,941
Others	**26,556**	20,226*
	164,951	150,420

For information about the Company's exposure to currency and liquidity risks for part of the payables balances, see Note 31 – Financial Instruments

NOTE 13 - PROVISIONS

	December 31, 2010
	NIS thousands
Balance at January 1, 2010	9,079*
Provisions during the period	81,516
Provisions realized during the period	(124)
Provisions eliminated during the period	(1,205)
Balance at December 31, 2010	**89,266**

During the normal course of business, various lawsuits were filed against the Company.

For information about the lawsuits and amounts of the exposure, see Note 21.

* Reclassified

NOTE 14 – DEBENTURES

A. On July 31, 2007, the Company issued debentures at a par value of NIS 620 million in a private issue to institutional investors. The debentures (Series A) were listed on the TACT-institutional system of the Tel Aviv Stock Exchange. The debentures were rated for the issuance by S&P Maalot ("the Rating Agency") at BBB-/stable. In August 2008, the Rating Agency validated that rating. The proceeds from the issuance, net of costs, amounted to NIS 614 million.

The debentures (Series A) are repayable in eight annual payments of principal and interest on July 5th of each of the years 2010 to 2017. The principal payments in each of the years 2010 to 2013 will be at a rate of 8% of the par value of the debentures (Series A), and the principal payments in each of the years 2014 to 2017 will be 17% of the par value of the debentures(Series A) . The debentures (Series A) are linked to the CPI commencing on June 2007, and bear annual linked interest at a rate of 8.4% per year (subject to various possible adjustments according to the terms of the debenture Series A), payable in semi-annual payments in January and July of each of the years 2009-2017.

The Company did not undertake to list the debentures (Series A) on the TASE, however, if they are listed, the annual interest paid on them will be reduced to 7.4% from that date. Pursuant to the terms set at the time of issuance of the debentures (Series A), since the debentures (Series A) were not listed by July 31, 2008, the annual interest rate they bear increased to 8.4% from that date. If the debentures (Series A) are listed for trading at a later date, then the annual rate of interest on them will decrease to 7.4% from that date.
In addition, if the Company fails to comply with the terms set out in the financing agreement with the banks, and as a condition for the banks ceding the breach, the Company will undertake to pay to the banks, for the bank credit, an additional margin on the bank interest, and if the debentures (Series A) are not listed at that time, then as long as the banks are paid the additional margin and the debentures (Series A) are not listed, the Company will pay the holders of the debentures (Series A) additional annual interest at the same rate.

In addition, Deed of Trust A stipulates standard events (such as insolvency proceedings, breach and exercise of liens on most of the Company's assets), which, should they occur, will allow immediate call for repayment pursuant to the provisions in the deed of trust, and establishes the right to call for immediate payment if the bank guarantees are exercised or another debenture series is called for immediate repayment, if the balance for settlement exceeds the amount set out in the deed of trust.

B. In November 2010 the Company raised NIS 450 million in a private issue of debentures (Series B) to institutional investors. The debentures (Series B) are registered and listed on the TACT-institutional system of the TASE. S&P Maalot rated the debentures as ilA for the issuance.

Debentures (Series B) are repayable in seven annual payments of the principal, in November 2013 to 2019. The annual payments in each of the years 2013 through to 2017 will be at a rate of 14% of the par value of the debentures (Series B), and the payment of the principal for each of the years 2018 and 2019 will be at a rate of are 15% of the par value of the debentures (Series B). The debentures (Series B) are linked to the CPI commencing in September 2011, and bear annual linked interest at a rate of 5.85% per year (subject to various possible adjustments according to the terms of the Series B debenture), which are payable in semi-annual payments in May and November of each of the years from 2011 through to 2019.

The Company did not undertake to list the debentures (Series B) on the TASE, however, if they are listed, the annual interest paid on them will be reduced by 0.54% from the later of the listing date or two years after issuance of the debentures, as long as the debentures will be listed for trading. In addition, if debentures (Series B) are downgraded to ilBBB by Maalot scale or its equivalent scale of another grading company, the debenture holders will be entitled to an additional 0.5% on the annual interest rate, from the date of the downgrade and for as long as this is in effect. If the rating is downgraded to below ilBBB, holders of debentures (Series B) will be entitled to an additional 0.5% on the annual interest rate, for each notch on the rating scale, for as long as the downgraded rating is in effect. For this purpose, debentures (Series B) will be rated according to the lower of their ratings by the rating companies.

NOTE 14 – DEBENTURES (CONTD.)

B. (contd.)
If Bezeq provides a guarantee for the Company's debts towards the holders of debentures (Series B), under the terms stipulated in the deed of trust for these debentures, the annual interest rate of the debentures (Series B) will be reduced by 0.5% and any extra interest for the downgrading of these debentures will be cancelled.

Deed of trust (B) stipulates standard events which, should they occur (subject to the extension periods set out in the deed of trust), will allow immediate call for repayment of the debentures, subject to the provisions in the deed of trust. These events include the events set out in Deed of Trust A, with certain changes, including failure to deliver the financial statements to the trustee on the dates set out in the deed, a decrease in Bezeq's holding in the Company below the minimum rate stipulated in the deed (provided the Company remains a private company), a merger with another company (except for with Bezeq or one of its subsidiaries), or the sale of most of its assets under conditions stipulated in the deed, cancellation of the broadcasting license or termination of communication activities, as well as non-compliance with the financial covenants set out in the deed, based on the ratio between the Company's secured debts and its EBITDA (as defined in the deed of trust and subject to the amendment period set out in the deed).

Under the deed of trust, the Company's right to distribute dividends and repay them at the expense of shareholders loans is contingent on compliance with the financial covenants, based on the ratio between the total secured debt and its EBITDA (as defined in Deed of Trust B, and subject to the amendment period set out in the deed). In respect of repayment of shareholders' loans, there is a further restriction whereby the repayment amount will not exceed the Company's cumulative net profit from the beginning of 2011 onwards, with neutralization of the Company's financing expenses for the shareholders' loans, and repayments and distributions.

According to the provisions in Deed of Trust B, if Trustee B receives a guarantee by Bezeq for the Company's liabilities to holders of debentures (Series B), and the rating of Bezeq is not downgraded to lower than ilAA- or the corresponding rating with another rating company, whichever is higher, then from that date, and as long as Bezeq's rating does not fall below that rating, the collaterals produced by the Company in favor of Trustee B will be cancelled, as well as the restriction on expansion of the series and the issue of additional securities secured by these collaterals the limitation in regard to repayment of shareholders loans and distribution of dividends and a number of causes for immediate redemption available to by Trustee B under Deed of Trust B (in addition to the decrease in the annual interest rate as set out above).

Debentures (Series A) and debentures (Series B) are each secured by a floating first lien, unlimited in amount, on all the Company's assets (apart for exceptions pursuant to the Communications Law), as well as a fixed first lien of unlimited amount on the Company's rights and assets, which encumbered in favor of the banks (other than exceptions as dictated by the provisions of the Communications Law). Said liens are equal (pari passu) to the liens in favor of holders of debentures (Series A) and the liens in favor of holders of debentures (Series B), and between them and the floating liens and the fixed lien created by the Company in favor of the banks to secure the bank credit.

NOTE 14 – DEBENTURES (CONTD.)

	December 31, 2010			
	Nominal interest (%)	Repayment year	Par value	Carrying amount
			NIS thousands	
Debentures A	8.4	2011-2017	**570,676**	**641,244**
Debentures B	5.85	2013-2019	**450,000**	**445,791**

Repayment dates

	December 31, 2010
	NIS thousands
2011	**56,063**
2012	**56,063**
2013	**119,298**
2014	**182,368**
2015	**182,368**
2016 onwards	**500,240**
	1,096,400

For information about liens in respect of the debentures, see Note 28.

NOTE 15 – LONG-TERM LOANS FROM INSTITUTIONS

In 2005, the Company signed agreements with three institutions according to which the institutions would grant the Company loans in the total amount of NIS 100 million.
The loans were linked to the CPI and bear annual interest at a rate of 11%. The loans were repayable with the addition of interest and linkage differentials, on December 31, 2013, but were repayable at an earlier date, subject to partial repayment of the loans received from the banks, under the terms set out in this agreement.

On November 11, 2010, the Company repaid its loans from institutions through early repayment.

NOTE 16 – LOANS FROM SHAREHOLDERS

A.

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Balance of the loans based on their nominal terms:		
Old shareholders' loans (1)	**2,249,570**	2,200,008
New shareholders' loans (2)		
Loans received at 5.5% interest	**379,929**	351,598
Loans received at 11% interest	**1,263,679**	1,113,108
	3,893,178	3,664,714
Net – received loan amounts in excess of the fair value upon receipt, after cumulative reduction (at the effective interest rate) (3)	**(1,592,792)**	(1,682,827)
	2,300,386	1,981,887

(1) The loans extended to the Company by its shareholders until July 10, 2002 ("the Old Shareholders' Loans"), in the amount of NIS 2.25 million, are linked to the known CPI, do not have a repayment date and do not bear interest. These loans were received in accordance with their pro-rata holdings in the Company upon receipt of the loans.

(2) Pursuant to the agreement between the shareholders and the Company as at December 30, 2002, it was decided that the loans extended by some of the Company's shareholders as from July 10, 2002 ("the New Shareholders Loans"), will have preference over the Old Shareholders Loans. In accordance with the agreement, the New Shareholders Loans will be eligible for full settlement by the Company before any dividend is distributed by the Company and/or the repayment of the Old Shareholders Loans extended to the Company by the shareholders, and subject to the Company's cash flows and liabilities under the agreements with the banks.

The New Shareholders Loans that were received before April 27, 2003, are linked to the known CPI and bear annual interest at a rate of 5.5%, while the New Shareholders Loans that were received after this date, based on an amendment to the aforesaid agreement, are linked to the known CPI with the addition of annual interest at a rate of 11%. No repayment dates were set for the new loans as well.

(3) The shareholders loans were included in the financial statements at their fair value at the time received. The fair value of the loans was determined according to the current value of the expected cash flows for repayment of the loans, taking into consideration the dates on which the shareholders may make an initial request for repayment of the loans (in accordance with the restrictions that the shareholders consented to in the agreements with the banks and debentures holders), and the interest rates applicable to loans with similar risks upon receipt of the loans. The interest rate taken into account as aforesaid, which represents the effective interest rate for the loans, is 12%.

When a change in the terms of the loans results in a difference of over 10% in the discounted cash flows, the difference between the expected cash flows prior to the changes which are discounted at the interest rate on the date of the loans were provided, and their discounted value at the interest rate on the date of the changes, is recognized in financing income.
The difference between the current value of the new cash flows, which are discounted at the interest rate on the date of the change, and the old cash flows, which are discounted at the interest rate on the date of the change, is recognized in capital reserve under equity.

NOTE 16 – LOANS FROM SHAREHOLDERS

A. (contd.)

(3) (contd.)
In 2007, as part of rating the debentures with the Rating Agency, the Company undertook to the Rating Agency (and to it alone) that it shall not make payment on account of the shareholder loans before the end of the life of the debentures

The interest rate on the date of the change was determined in accordance with a professional opinion received by the Company from an external consultant, stating that the interest rate for discounting the interest-free shareholder loans is 15.63%, and the interest rate for discounting the shareholder loans bearing interest at a rate of 5.5% is 15.58%.
Based on these rates, the difference between the expected cash flows prior to the change which are discounted according to the 12% interest rate at the time the loans were received and their discounted value of 15.63% or 15.58% at the time of the change, accordingly, which amounted to NIS 213 million, was attributed to the financing income.

The difference between the current value of the expected cash flows based on the new repayment dates and the current value of the cash flows which were expected based on the repayment dates prior to any change is discounted according to the interest rate at the time of the change, 15.63% or 15.58%, which amounted to NIS 348 million, was attributed to capital reserves.

The Company's right to distribute dividends for debentures (Series B) and repay them is contingent on the shareholders' loans. See Note 14(B). This is not a material change in the terms as set out in section A, therefore it had no effect on the Company's financial statements.

B. In accordance with the agreement described in section 2 above, the shareholders that provided the new shareholders loans were awarded rights to receive additional shares in the Company or options exercisable for Company shares.

Accordingly, the shareholders were allocated additional shares in the Company or options exercisable for Company's shares. The options are exercisable at any time and without additional consideration, and they are negotiable as though they were shares, subject to the approval of the banks according to the financing agreements.

Exercise of the options allocated and changes in certain holdings in the Company are contingent on regulatory approvals.
As at the date of the approval of these financial statements, these approvals have not yet been received. Fur further details, see Note 1A.

NOTE 17 – LONG-TERM TRADE PAYABLES

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Open accounts with related parties	**54,264**	8,340
Notes and checks for repayment	**-**	661
	54,264	9,001*

* Reclassified

The Company and Bezeq formulated a debt restructuring arrangement for the debt balance of NIS 31.5 million owed by the Company to Bezeq. Under the arrangement, the Company will repay the debt to Bezeq in 36 equal monthly installments plus interest at prime + 1.5%. In October 2010, an agreement was approved to defer part of the payments under this debt arrangement and also to defer payments that the Company owes Bezeq under the previous agreement between the Company and Bezeq. Under the agreement, 18 payments under the agreement and the 15 payments remaining under the previous agreement will be deferred for 18 months, where in the deferral period, the payments will bear annual interest of prime + 3%. The agreement may be terminated by prior notice, under the provisions stipulated therein.

NOTE 18 – EMPLOYEE BENEFITS

Employee benefits include post-employment benefits, termination benefits, short-term benefits and share-based payments.
The Company has defined benefit plans for post-employment benefits and it makes contributions to central severance pay funds and appropriate insurance policies.
The Company also has a defined contribution plan for some of its employees who are subject to Section 14 of the Severance Pay Law, 5723-1963.

Regarding share-based payments see Note 19 – Share-based Payments.

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Current value of obligations	**11,891**	11,610
Fair value of plan assets	**(5,195)**	(6,011)
Liability recognized for a defined benefit plan	**6,696**	5,599
Other liabilities	**14,731**	11,641*
Total employee benefits	**21,427**	17,240
Presented under the following items:		
Other payables	**14,731**	11,641*
Long-term employees benefits	**6,696**	5,599*
	21,427	17,240

NOTE 18 – EMPLOYEE BENEFITS (CONTD.)

Post-employment benefit plans – defined benefit plan

A. Change in the current value of the defined benefit obligations

	2010	2009
	NIS thousands	NIS thousands
Obligation in respect of a defined benefit plan at January 1	**11,610**	11,465*
Current service cost	**1,346**	1,015
Finance expenses with respect to obligations	**650**	503
Actuarial gains recognized in other comprehensive income	**85**	(834)
Benefits paid according to the plan	**(1,800)**	(539)
Balance of obligations at end of year	**11,891**	11,610

B. Change in plan assets

	2010	2009
	NIS thousands	NIS thousands
Fair value of plan assets at January 1	**6,011**	5,246
Amounts deposited in the plan	**929**	785
Expected return on plan assets	**353**	318
Actuarial gains (losses) recognized in other comprehensive income	**(1,450)**	(297)
Benefits paid according to the plan	**(648)**	(41)
Fair value of plan assets at end of year	**5,195**	6,011

* Reclassified

C. Expense recognized in profit or loss

	2010	2009
	NIS thousands	NIS thousands
Current service cost	**1,346**	1,015
Interest for obligation	**650**	503
Expected return on plan assets	**(353)**	(318)
	1,643	1,200

The expense is included in the following items in the statement of income:

	2010	2009
	NIS thousands	NIS thousands
Cost of sales	**738**	558
Selling and marketing expenses	**460**	345
General and administrative expenses	**148**	112
	1,346	1,015

NOTE 18 – EMPLOYEE BENEFITS (CONTD.)

D. Actuarial gains and losses recognized directly in other comprehensive income

	2010	2009
	NIS thousands	NIS thousands
Amount accrued as at January 1	**2,508**	1,971
Amount recognized in the period	**1,535**	537
Amount accrued as at December 31	**4,043**	2,508

E. Main actuarial assumptions

	2010	2009
	%	%
Discount rate at December 31	**1.7**	2.9
Future salary increases	**2**	3

Assumptions regarding future mortality are based on published statistics and mortality tables.
The expected long-term yield rate on the assets is 2.93%. This rate is based on the asset portfolio as a whole and not on the yield of the separate asset groups. The return is based exclusively on historical returns, without adjustments.

F. Historical information

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Present value of the defined benefit obligation		
Defined benefit	**11,891**	11,610
Fair value of plan assets	**(5,195)**	(6,011)
Deficit in the plan	**6,696**	5,599

G. Post-employment benefit plans – defined contribution plan

	Year ended December 31	
	2010	2009
	NIS thousands	NIS thousands
Amount recognized as an expense in respect of a defined deposit plan	**9,526**	9,381

NOTE 19 – SHARE-BASED PAYMENT

In September 2008, 4,250,000 options of Bezeq were allocated to the CEO of the Company. The options are exercisable into Bezeq shares at the exercise price of NIS 5.24 per option (at the allocation date, the exercise price is NIS 5.24, adjusted to distribution of dividends by Bezeq as from the allocation date). The fair value of the options on the allocation date was NIS 10.28 million. The options are vested in three equal annual lots. Up to the reporting date, two out of the three lots have vested. In regard to the third lot, Bezeq has notified the CEO of the Company that it is examining the possible implications of changes which occurred in the Company's structure and holdings on the third lot.

A. Number of Bezeq options

	Number of options
	2010
	in thousands
Balance at January 1	4,250
Allocated during the period	-
Balance at December 31	4,250

B. Additional details

The fair value of the services received in consideration of the allocated options is based on the fair value of the allocated options, measured on the Black and Scholes model, based on the following parameters:

Fair value at the allocation date	10,280
Parameters taken into account in fair value	
Bezeq share price	6.18
Exercise price	5.24
Anticipated fluctuations (weighted average)	23.1%- 23.8%
Useful life of the option (projected weighted average)	5
Risk-free interest rate	5.1%-5.3%
<u>Other information (not taken into account):</u>	
Share price immediately before the board of directors' decision	6.37
Share price immediately before the allocation	5.92

The anticipated fluctuations were based on historical fluctuations of Bezeq's share prices. The life of the options was determined on the basis of management estimates regarding the period of time the employees will hold the options, taking into consideration their positions at the Company and the Company's previous experience regarding termination of employment. The risk-free interest rate was determined on the basis of the NIS government bonds, with the time to maturity being equal to the expected life of the options.

The total expense recorded for the options in the year ended December 31, 2010, and attributed to administrative and general expenses in the statement of income amounted to NIS 2.46 million.

C. Benefits

In 2010, the CEO of the Company received payment in accordance with his revised employment contract.

NOTE 20 – AGREEMENTS

1. At December 31, 2010, the Company has agreements for the acquisition of broadcasting rights. In the year ended December 31, 2010, acquisition of these rights amounted to NIS 94 million.

2. At December 31, 2010, the Company has agreements for the acquisition of channels. In the year ended December 31, 2010, expenses for use of channels acquired by the Company amounted to NIS 253 million.

3. The Company has a primary operational leasing contract for the building it occupies. The lease expires in 2014, with an option to extend the lease for another five years. The rental fees are linked to the CPI. The Company also has several other leasing contracts for various periods.

The expected rent for the forthcoming years, calculated according to the rent on December 31, 2010, is as follows:

	NIS thousands
2011	9,885
2012 to 2014	21,922

4. Operating lease

A. The Group has a number of operating lease agreements for periods of up to 36 months for the vehicles it uses. The balance of the contractual annual lease payments, calculated according to the payments in effect at December 31, 2010, is NIS 17 million

B. In 2009, the Company purchased several vehicles from a vehicle importer. This transaction is accounted for as an operating lease. The expected annual payments amount to NIS 4.4 million.

5. Royalties: In accordance with the terms of the license, the Company has a liability to pay royalties to the State of Israel, calculated on the basis of income from broadcasting services as described in the license.

The rate of royalties was amended in 2006 according to the Communications Regulations 5766-2006. Following the amendment, the rate of royalties applicable is as follows: 2008 - 2%, 2009 – 1.5%, 2010 and thereafter – 1%.
For information about the rate of royalties for 2011 and thereafter, see Note 32.

6. In accordance with the licensing requirements and the regulations set forth by the Cable and Satellite Broadcasts Council (“the Council”), for each of the years 2006 through 2011, the Company is required to invest no less than 8% of its income from subscription fees in local production content broadcasts in that year (the Company is required to invest its share in certain broadcasts). In view of the Company’s shortfall in investing in certain categories of broadcasts, the Company is required to complete the shortfall in the relevant categories in 2010 and 2011.

7. Agreement with NDS Limited ("NDS"): The Company engaged in several agreements with NDS to acquire services in respect of the Company's encoding, broadcasting and receiving systems and hardware for these services.
In 2010 and 2009, the Company's payments to NDS amounted to NIS 26.893 million and NIS 31.283 million, respectively.

NOTE 20 – AGREEMENTS (CONTD.)

8. In August 2000, the Company engaged in a three-way contract to acquire decoders from Eurocom Marketing (1986) Ltd. ("Eurocom") and Advanced Digital Broadcast Ltd ("ADB"). Eurocom is an interested party of the Company. The contract included, inter alia, the supply of ongoing maintenance services and repair services (after the warrantee period) by ADB.

In 2010 and 2009, the Company's payments to Eurocom for the acquisition of decoders amounted to NIS 88 million and NIS 57 million, respectively.

9. The Company has an agreement with Space Communications Ltd. (“Spacecom”) for the supply of space segments.
In 2010 and 2009, the Company's payments to Spacecom amounted to NIS 87 million and NIS 99 million, respectively.

10. As from December 2010, subscribers can no longer be signed up for special offers that include a term of commitment by the subscriber to use the services for more than 18 months. This restriction does not apply to subscribers that signed up for special offers up to December 2010. It was also prohibited to offer subscribers various terms of commitment for different service components. In accordance with the decision of the Council, as of January 2011, the Company is entitled to collect the cost of the benefit from subscribers who signed up for a special offer that includes a term of commitment and ask to be disconnected from its broadcasts prior to the end of the term of commitment. which equals the lower of the following two amounts: Return of the cost of the benefit stipulated in the special offer or the balance of the payments the subscriber would have had to pay had the subscriber remained connected to the Company’s services until the end of the term of commitment.

11. In July 2010, the Company signed an agreement with HOT. According to the agreement, the Company will pay HOT an agreed amount to settle its demands in respect of the use of infrastructure in the subscriber’s home up to the end of 2010. In addition, according to the agreement, as from 2011, there will be no obligation for either company to pay the other for the use of wiring. In September 2010, the Company and HOT submitted a request to the Ministry of Communications concerning amendment of the administrative provisions, mainly cancellation of the duty to give the other licensee prior notice before connecting a subscriber in the event that a subscriber switches licensees so that a licensee to which a subscriber connects will forward the disconnection notice from the subscriber to the licensee from which the subscriber was disconnected only after the connection is made to the other licensee. The Ministry of Communications has not yet given its decision on the matter.

NOTE 21 – CONTINGENT LIABILITIES

1. Guarantees

To assure its obligations, the Company placed collateral in the amount of NIS 40 million (including guarantees to the State of Israel in the amount of NIS 38 million).

2. Legal claims

Legal claims were filed or are pending against the Company (hereinafter in this section: “legal claims”).
In the opinion of the management of the Company, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements (Note 13) include appropriate provisions, where provisions are required to cover the exposure resulting from such claims.

In the opinion of the management of the Company, the additional exposure at December 31, 2010, due to claims filed against the Company on various matters and which are likely to be realized, amounts to NIS 1,073,621,000. These amounts and all the amounts of the claims in this Note are before addition of interest.

NOTE 21 – CONTINGENT LIABILITIES (CONTD.)

2. Legal claims (contd.)

Below are details of the material contingent claims of the Group at December 31, 2010, classified into groups with similar characteristics.

A. Employee claims

During the normal course of business, collective and individual claims were filed against the Company by employees and former employees of the Company. These are claims which are primarily allegations of non-payment of salary components and delay in salary payment. At December 31, 2010, the total amount of these claims amounted to NIS 1.644 million. In the opinion of the management of the Company, which is based, inter alia, on legal opinions as to the likelihood of success of the claims, appropriate provisions amounting to NIS 724,000 have been included in the financial statements, where provisions are required to cover the exposure resulting from such claims.

B. Customer claims

During the normal course of business, claims were filed against the Company by its customers. These are mainly motions for approval certification of class actions and the ensuring claims concerning allegations regarding the unlawful collection of payment and impairment of the services provided by the Company. At December 31, 2010, these claims amount to NIS 1,228,573,000. In the opinion of the management of the Company, based, inter alia, on legal opinions as to the likelihood of success of the claims, the financial statements include appropriate provisions of NIS 9.028 million, where provisions are required to cover the exposure resulting from such claims.

Of these claims, there are claims amounting to NIS 1,006 million, which cannot yet be estimated. These claims include the following:
On October 7, 2010, a motion for approval of a class action against the Company was filed in the Tel Aviv-Jaffa district court for NIS 98 million. According to the applicant, the Company did not comply with its obligation to provide the applicant and its customers with a document that outlines their right to cancellation should they make a change and/or addition to the service provided to them under the ongoing transactions with it, and as a result, the applicant allegedly incurred financial damages of NIS 124, which is the difference between the payment the applicant made in respect of the new STB and the amount paid for STB converter prior to the change over a period of three months, and non-financial damage of NIS 50 in respect of harm to personal autonomy. The applicant estimated that the total number of members of the relevant group is approximately one million subscribers. The final date for submitting the Company's response to the motion for certification is March 23, 2011.

On November 1, 2010, a motion for approval of a class action against the Company was filed in the central district court, for NIS 258 million (sums in respect of monies unlawfully collected each month from each and every member of the group are expected to be added to this amount). According to the applicant, the Company materially violated the provisions of the Consumer Protection Law regarding a transaction for a defined period of time, and this due to the failure to send a notice to its customers of the end of their term of commitment and collection of improper payments at the end of the term of commitment. The applicant further argues that the Company conditioned the return of the payments unlawfully collected from the customers upon the engagement with the Company on another long-term commitment. The applicant contends that as a result, she incurred financial damage of NIS 568, which is the full amount she paid as subscriber fee after the end of the term of commitment. In addition, the applicant is suing for NIS 5,000 as exemplary damages and/or damages in respect of non-financial damage incurred by the applicant in respect of the alleged breaches of the provisions of the Consumer Protection Law. The applicant estimates that the relevant group numbers 570,000 customers. The Company is required to submit its response to the motion by March 6, 2011.

NOTE 21 – CONTINGENT LIABILITIES (CONTD.)

2. Legal claims (contd.)

B. Customer claims (contd.)

On December 13, 2010, a motion for approval of a class action against the Company was filed at the Tel Aviv-Jaffa district court for NIS 600 million. The applicant alleges that the Company violated its obligation to its customers by omitting broadcasts it is committed to air in the basic package, removed channels without approval, did not comply with the obligation to invest in quality genres and violated obligations regarding commercials, promos and marketing and commercial content. The applicant alleges that as a result, he incurred damage estimated at NIS 2,180. This amount comprises NIS 1,680, which is 10% of the total subscription fee the applicant paid in the seven years he was a subscriber of the Company, as damages in respect of the damage he incurred due to non-broadcast of the broadcasts the Company is obligated to air, and non-financial damage of NIS 500 in respect of harm to personal autonomy. The applicant defined the group as all of the respondent's subscribers in the seven years prior to the filing of the motion. He estimates that the group numbers 800,000 subscribers. The final date for the Company to file its response to the application for certification is March 20, 2011.

On December 16, 2010, a motion for certification of a class action against the Company was filed at the Tel Aviv-Jaffa district court for NIS 50 million. The applicant alleges that the Company violated its obligation to its subscribers with hearing disabilities by not fulfilling its duties under the Equal Rights for People with Disabilities Law, 5758-1998 and under the Television Broadcasts (Subtitles and Sign Language) Law, 5765-2005 violates the directives of the Council in this regard. As alleged in the claim, the amount of damages claimed per customer is NIS 10,000. According to the estimate of the plaintiff, at least 25,000 of the people suffering from hearing impairment (of the 50,000 he claims are defined as hearing impaired) are customers of the Company. The Company has not yet filed its response to the motion for certification.

C. Supplier and communication provider claims

During the normal course of business, various legal claims have been filed against the Company by suppliers who supply the Company with goods and/or services. The main claim was filed for alleged damage caused to a supplier as a result of the Company's negligence.

At December 31, 2010, these claims amounted to NIS 64,331,000. The financial statements include appropriate provisions amounting to NIS 161,000, where provisions are required to cover the exposure resulting from such claims.

3. Other contingent liabilities

Pursuant to an immediate report issued by HOT Communication Services ("the Cable Company"), in July 2010, there was a ruling in the arbitration between the Cable Company and Association of Composers, Authors and Publishers of Music in Israel (ACUM) regarding a mechanism for calculation of the annual royalties for the use of works, the rights of which are protected by ACUM. According to this report, the arbitration ruling accepted, in principle, the model for calculation of royalties presented by ACUM in the proceeding, with the exception of certain changes, and determined that this model would also apply to the difference in royalties from 2003 onward, to be calculated by the parties to the arbitration in a settlement. The Cable Company announced that it intends to appeal the arbitrator’s ruling. Since the arbitrator’s ruling and the other arbitration documents were not submitted to the Company, the Company does not know which model was adopted and the reasoning behind the arbitrator’s ruling. However, pursuant to the agreements between the Company and ACUM, the royalties paid to ACUM since 2003 may be updated, inter alia, depending on the agreement to be reached by the Cable Company and ACUM, and according to ACUM, also subject to the arbitrator’s ruling.

NOTE 21 – CONTINGENT LIABILITIES (CONTD.)

3. Other contingent liabilities (contd.)

Consequently, the Company's management believes that after the arbitration ruling, the Company could be required to pay significant sums retroactively. In view of the above, the Company revised its estimate of the royalties as from 2003. The updated estimate was prepared on the basis of model for calculation of royalties which was received from ACUM shortly after the arbitration ruling, with adjustments in accordance with the estimate of the Company's management. This served as the basis for the material provisions that the Company included in its financial statements.

NOTE 22 – EQUITY

A. Share capital

The equity consists of ordinary shares of NIS 1 par value each, as follows:

	December 31, 2010	December 31, 2009
	Nmber of shares and amount in NIS	
Issued and paid up share capital	**29,896**	29,896
Registered capital	**39,000**	39,000

B. Option warrants for shareholders

See Note 16(B).

NOTE 23 – COST OF REVENUES

	Year ended December 31		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Wages and incidentals	**148,545**	132,172	117,294
Content costs	**350,688**	295,608	278,285
Utilized broadcasting rights	**168,799**	180,826	168,478
Use of space segments	**89,990**	94,228	89,997
Depreciation and amortization	**237,260**	200,679	217,873
Car allowance	**25,409**	19,055	20,427
Royalties	**10,944**	13,581	17,555
Other	**97,213**	105,952	181,262
	1,128,848	1,042,101	1,091,171

NOTE 24 – SALES AND MARKETING EXPENSES

	Year ended December 31		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Wages and incidentals	**29,805**	27,913	28,919
Advertising	**67,624**	60,897	62,862
Marketing consultation	**1,729**	1,603	1,791
Car allowance	**8,786**	7,921	8,739
Depreciation	**32,165**	20,862	21,510
Other	**3,093**	3,116	4,341
	143,202	122,312	128,162

NOTE 25 – GENERAL AND ADMINISTRATIVE EXPENSES

	Year ended December 31		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Wages and incidentals	**54,347**	45,490	49,119
Share-based payment	**2,460**	5,295	1,636
Professional consultation and fees	**10,100**	7,738	8,966
Rental and maintenance fees	**13,181**	12,727	12,706
Depreciation	**15,307**	12,662	10,497
Provision for doubtful and bad debts	**805**	1,764	2,352
Subcontractors (mainly for system maintenance)	**20,462**	19,648	18,726
Other	**15,899**	12,481	12,149
	132,561	117,805	116,151

NOTE 26 - FINANCING EXPENSES, NET

Recognized in profit or loss

	Year ended December 31		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Income from interest on bank deposits	**(316)**	(77)	(178)
Change in fair value of financial assets at fair value through profit and loss	**(351)**	(5,518)	(35,883)
Income from linkage and other differentials	**(8,646)**	(2,752)	(15,744)
Financing income recognized in profit and loss	**(9,313)**	(8,347)	(51,805)
Expenses for shareholder loans	**228,464**	258,183	255,164
Expenses for discounting of shareholder loans	**90,035**	42,190	7,797
Change in fair value of financial assets at fair value through profit and loss	**7,244**	4,558	43,579
Interest expenses for financial liabilities measured at reduced cost	**127,544**	124,189	127,392
Expenses for linkage differences	**19,449**	29,343	34,163
Expenses from exchange rate changes	**277**	3,253	12,825
Other financing expenses	**27,070**	16,557	11,691
Financing income recognized in profit and loss	**500,083**	478,273	492,611
Net financing expenses recognized in profit and loss	**490,770**	469,926	440,806

NOTE 27 – INCOME TAX

A. Income tax expense components

	Year ended December 31		
	2010	2009	2008
	NIS thousands	NIS thousands	NIS thousands
Current tax expense			
For the current period	**1,188**	972	1,048
In respect of preceding years	**-**	(227)	-
	1,188	745	1,048

NOTE 27 – INCOME TAX (CONTD.)

B. Deferred tax assets and liabilities

At the reporting date, the Company has losses and deductions for inflation of NIS 4.7 billion for tax purposes carried forward to the next year (in 2009, NIS 4.4 billion).
Loss balances and deductions carried forward to the next year are CPI linked to the end of 2007.

The deductible temporary differences and tax losses do not expire under current tax legislation. The Company does not create deferred tax assets since it is not probable that future taxable profit will be available against which the Group can utilize the benefits.

C. Tax assessments

The Company has final tax assessments up to and including 2004 and tax assessments that are considered as final up to 2005.

D. Tax authority hearings

In February 2010, the Company reported to the Tax Authority a payment deficit of NIS 2.85 million (tax principal), for value added tax for 2006 and thereafter, which was discovered in an internal audit by the Company for the yes-WOW venture (offering a service bundle including DBS television services, infrastructure connection to the internet provided by the Company and internet access services provided by Bezeq International Ltd.).

At the date of approval of the financial statements, this amount was paid to the tax authorities.

In August 2010, the Company received tax assessments in which the Tax Authority claimed NIS 9.6 million (including interest and linkage differences) for the period commencing in January 2006 and ending in July 2010.
The management of the Company believes, based, inter alia, on the opinion of its legal counsel, that it is likely that the assessment will be cancelled in full.

NOTE 28 – LIABILITIES SECURED BY LIENS AND RESTRICTIONS IMPOSED WITH RESPECT TO LIABILITIES

A. The Company's secured liabilities and collateral are as follows:

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Debentures	**1,087,035**	680,553
Borrowings from banks	**606,248**	890,734
Guarantees	**40,319**	39,460

B. To secure these liabilities and collateral, the Company recorded a lien on all its assets, including share capital.

NOTE 28 – LIABILITIES SECURED BY LIENS AND RESTRICTIONS IMPOSED WITH RESPECT TO LIABILITIES (CONTD.)

C. The terms of loans and credit facility that the Company received from banks (NIS 634 million at December 31, 2010) impose the following restrictions: the lien or sale of certain assets, receipt of credit from other banks (without the prior approval of the lending bank), distribution of a dividend, repayment of shareholder loans, transactions with interested parties, changes in the shareholding ratio of shareholders, the Company's compliance with various licenses granted to it, purchase of securities by the Company and the establishment of a subsidiary, and the issuance of shares or other securities of the Company. The parameters for compliance with the financial covenants are measured quarterly and the objectives of one of them change in each quarter. Non-compliance with the financial covenants (subject to the extension term set out in the agreement) awards the banks the right to demand early settlement of the loans that the Company received.

At December 31, 2010, the Company is in compliance with the covenants in the amended financing agreement.

NOTE 29 - FINANCIAL RISK MANAGEMENT

A. General

The Company is exposed to the following risks from the use of financial instruments:

- Credit risk
- Liquidity risk
- Market risk (including currency and interest risks)

This Note presents information about the Company’s exposure to each of the above risks, and the Company’s objectives, policies and processes for measuring and managing risk.

B. Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises mainly from trade receivables.
Management has a credit policy and the Company's exposure to credit risks is monitored on a regular basis.
The Company regularly monitors trade receivables and the financial statements include provisions for doubtful debts which properly reflect, in management’s estimation, the loss inherent in debts for which collection is uncertain.

C. Liquidity risk

Liquidity risk is the risk of the Company being unable to meet its financial liabilities repayable by cash or other financial asset. The Company’s approach to managing liquidity risk is to ensure, as far as possible, the degree of liquidity that is sufficient to meet its liabilities on time, under normal conditions and stressful conditions, without causing it unexpected losses or harming its goodwill.

D. Market risk

Market risk is the risk that changes to market prices such as exchange rates and interest rates will impact the Company's income or the value of its holdings in financial instruments. The objective of market risk management is to manage and supervise the exposure to market risks under standard parameters, by maximizing the risk yield.

NOTE 30 - FINANCIAL INSTRUMENTS

A. Credit risk

(1) Exposure to credit risk

The carrying amount of the financial assets represents the maximum credit exposure. The maximum exposure to credit loss at the reporting date is described in the table below:

	December 31, 2010	December 31, 2009
	Number of shares and amount in NIS	
Trade receivables	**168,847**	160,152
Other receivables	**7,994**	9,677*
	176,841	169,829

* Reclassified

(2) Aging of debts and impairment losses

	December 31, 2010	December 31, 2009
	Number of shares and amount in NIS	
Not past due	**166,200**	156,061
Past due up to one year	**10,106**	8,152
Past due one to two years	**2,925**	7,693
Past due more than two years	**5,233**	3,917
	184,464	175,823
Less provision for doubtful debts	**(7,700)**	(9,013)
Total	**176,764**	166,810

(3) Changes in provision for doubtful and bad debts:

	December 31, 2010	December 31, 2009
	Number of shares and amount in NIS	
Balance at January 1	**9,013**	8,730
Increase (decrease)	**(1,313)**	283
Balance at December 31	**7,700**	9,013

NOTE 30 - FINANCIAL INSTRUMENTS (CONTD.)

B. Liquidity risk

Below are the contractual repayment dates of financial liabilities, including interest payments. This aging does not include the impact of netting agreements.

	December 31, 2010						
	Carrying amount	Contractual cash flows	6 months or less	6-12 months	1-2 years	2-5 years	More than five years
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Non-derivative financial liabilities:							
Credit from banks at variable interest	85,735	85,735	85,735	-	-	-	-
Credit from banks at variable interest – long-term loan	156,154	164,127	11,508	152,619	-	-	-
Credit from banks at fixed interest	364,358	424,460	29,229	28,845	78,227	288,159	-
Debentures, including accrued interest	1,117,317	1,635,507	40,368	96,130	136,791	459,126	903,092
Loans from shareholders	2,300,387	3,893,207	-	-	-	-	3,893,207
	4,023,951	6,203,036	166,840	277,594	215,018	747,285	4,796,299
Derivative financial liabilities:							
Forward exchange contracts, net	2,929	2,929	2,929	-	-	-	-

NOTE 30 - FINANCIAL INSTRUMENTS (CONTD.)

B. Liquidity risk (contd.)

	December 31, 2009						
	Carrying amount	Contractual cash flows	6 months or less	6-12 months	1-2 years	2-5 years	More than five years
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Non-derivative financial liabilities:							
Credit from banks at variable interest	44,504	44,504	44,504	-	-	-	-
Credit from banks at fixed interest	846,230	976,660	186,350	141,301	290,841	358,168	-
Debentures, including accrued interest	708,778	985,762	29,013	83,352	107,761	357,452	408,184
Loans from institutions	181,729	275,956	-	-	-	275,956	-
Loans from shareholders	1,982,166	5,164,460	-	-	-	-	5,164,460
	3,763,407	7,447,342	259,867	224,653	398,602	991,576	5,572,644
Derivative financial liabilities:							
Forward exchange contracts, net	989	989	989	-	-	-	-

NOTE 30 - FINANCIAL INSTRUMENTS (CONTD.)

C. CPI and foreign currency risks

(1) Foreign currency and CPI risk for the Company's financial instruments are as follows:

	December 31, 2010				
	Unlinked	CPI-linked	In foreign currency or foreign currency linked (mainly USD)	Non-financial items	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Assets					
Trade receivables	164,889	-	3,958	-	168,847
Other receivables	7,983	2	9	3,156	11,150
Total assets	172,872	2	3,967	3,156	179,997
Liabilities					
Borrowings from banks	135,438	-	-	-	135,438
Trade payables	243,135	-	112,636	-	355,771
Other payables	62,092	77,452	2,938	22,469	164,951
Debentures	-	1,030,973	-	-	1,030,973
Current maturities for debentures	-	56,062	-	-	56,062
Loans from shareholders	-	2,300,387	-	-	2,300,387
Bank loans	470,810	-	-	-	470,810
Long-term trade payables	54,264	-	-	-	54,264
Total liabilities	965,739	3,464,874	115,574	22,469	4,568,656
Surplus liabilities over assets	792,867	3,464,872	111,607	19,313	4,388,659

NOTE 30 - FINANCIAL INSTRUMENTS (CONTD.)

C. CPI and foreign currency risks (contd.)

(1) Foreign currency and CPI risk for the Company's financial instruments are as follows: (contd.)

	December 31, 2009				
	Unlinked	CPI-linked	In foreign currency or foreign currency linked (mainly USD)	Non-financial items	Total
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Assets					
Trade receivables	155,111	-	5,041	-	160,152
Other receivables	9,634*	2	41	1,520	11,197
Total assets	164,745	2	5,082	1,520	171,349
Liabilities					
Borrowings from banks	283,698	-	-	-	283,698
Trade payables	321,688*	-	83,701	-	405,389
Other payables	56,392*	76,087	-	17,941	150,420
Debentures	-	625,741	-	-	625,741
Current maturities for debentures	-	54,812	-	-	54,812
Loans from shareholders	-	1,981,887	-	-	1,981,887
Loans from institutions	-	181,729	-	-	181,729
Bank loans	607,036	-	-	-	607,036
Long-term trade payables	9,001	-*	-	-	9,001
Total liabilities	1,277,815	2,920,256	83,701	17,941	4,299,713
Surplus liabilities over assets	1,113,070	2,920,254	78,619	16,421	4,128,364

* Reclassified

(2) CPI and exchange rates of material currencies:

	December 31, 2010	December 31, 2009	Change (%) 2010	Change (%) 2009
CPI in points	**113.51**	110.57	**2.7**	3.9
USD exchange rate per 1 USD	**3.549**	3.775	**(6.0)**	(0.7)
Euro exchange rate per 1 Euro	**4.738**	5.442	**(12.9)**	2.7

NOTE 30 - FINANCIAL INSTRUMENTS (CONTD.)

D. Interest rate risk

Types of Interest of the Company's interest-bearing financial instruments:

	Carrying amount 2010	Carrying amount 2009
	NIS thousands	NIS thousands
Fixed-interest instruments		
Other receivables	**77**	3,020
Financial liabilities	**3,751,781**	3,690,679
Variable-interest instruments		
Financial liabilities	**241,889**	43,816

E. Fair value compared to carrying amounts

The carrying amount of assets and liabilities correspond with or are close to their fair values. Fair value of financial assets and liabilities, which are not stated at fair value:

	2010		2009	
	Carrying amount	Fair value	Carrying amount	Fair value
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Bank loans	**520,512**	**521,904**	846,230	841,671
Loans from institutions	**-**	**-**	181,729	192,263
Debentures, including accrued interest	**1,117,317**	**1,293,986**	708,778	714,603
	1,637,829	**1,815,890**	1,736,737	1,748,537

See Note 4 for the basis for determining fair value.

The interest rates used to discount estimated cash flows, when applicable, are based on the government yield curve at the reporting date plus an adequate credit spread, and in 2010 ranged between 5.5% and 6.62% (in 2009, 8.42%-9.23%).:

F. Derivative financial instruments

The Company has limited involvement in derivative financial instruments. The Company contracts such transactions to hedge its cash flows. See details in Note 30B.

NOTE 30 - FINANCIAL INSTRUMENTS (CONTD.)

G. Sensitivity test

Below are sensitivity tests for changes in the main market risks where changes will alter the values of assets and liabilities and affect the Company's net profit and equity.

(1) Sensitivity to changes in the CPI

The Company has financial instruments that are sensitive to changes in the CPI such as loans, debentures and customer deposits. The sensitivity analysis of 5% and 10% refers to the rate of deviation from an inflation assessment of 2% per year, based on the Inflation Target Center at the Bank of Israel.

Sensitivity analysis at December 31, 2010

Deviation rate from inflationary goal	10%	5%	(5%)	(10%)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Effect on equity and net profit	**(7,343)**	**(3,671)**	**3,671**	**7,343**

Sensitivity analysis at December 31, 2009

Deviation rate from inflationary goal	10%	5%	(5%)	(10%)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Effect on equity and net profit	(5,930)	(2,965)	2,965	5,930

(2) Sensitivity analysis of changes in the US dollar exchange rate

The Company has financial instruments that are sensitive to changes in the US dollar exchange rate, such as trade payables and forward transactions. The sensitivity analysis of 5% and 10% refers to the rate of change in the exchange rate.

Sensitivity analysis at December 31, 2010

Change in NIS/USD exchange rate (in NIS)	10%	5%	(5%)	(10%)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Effect on equity and net profit	**(1,612)**	**(806)**	**806**	**1,612**

Sensitivity analysis at December 31, 2009

Change in NIS/USD exchange rate (in NIS)	10%	5%	(5%)	(10%)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Effect on equity and net profit	(7,704)	(3,852)	3,852	7,704

(3) Sensitivity to change in interest rates

The Company has financial instruments that are sensitive to changes in interest rates such as financial liabilities to banks. The sensitivity analysis of 5% and 10% refers to the rate of change in the interest rate.

Sensitivity analysis at December 31, 2010

Rate of change in the interest rate	10%	5%	(5%)	(10%)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Effect on equity and net profit	**(5,169)**	**(2,599)**	**2,628**	**5,287**

Sensitivity analysis at December 31, 2009

Rate of change in the interest rate	10%	5%	(5%)	(10%)
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Effect on equity and net profit	(176)	(88)	88	176

NOTE 31 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

A. Transactions with interested and related parties

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Revenue (3)	**1,165**	12,196
Cost of revenue (1)	**101,251**	112,576
Administrative and general expenses	**2,376**	1,855
Financing expenses	**320,032**	302,303
Salary and benefits for interested parties employed by the Company (2)	**5,802**	8,367

(1) The expenses primarily include costs of leasing space segments from an interested party and operating costs of Bezeq Online call center (see Note 20).

(2) The Company's CEO participates in an options plan for shares in the parent company (see Note 19). In addition, on August 11, 2008, the Company's board of directors approved a two year options plan for the Company's CEO for 2009 and 2010, based on compliance with certain goals defined in the plan.

(3) Includes revenue from the sale of content to an interested party.

B. Balances with related parties

	December 31, 2010	December 31, 2009
	NIS thousands	NIS thousands
Note 16 – Loans from Shareholders	**2,300,387**	1,981,887
Current liabilities	**73,664**	77,902
Non-current liabilities	**54,253**	8,340
Other receivables	**77**	52

C. Additional details

(1) The Company has an agreement for the import and maintenance of digital satellite decoders from a company that is an interested party (see Note 20).
The cost of acquisition and maintenance of decoders amounted to NIS 88 million (in 2009 – NIS 57 million).

(2) For information about the options allocated to the Company's shareholders, see Note 16B.

NOTE 32 – MATERIAL EVENTS SUBSEQUENT TO THE REPORTING DATE

A. In February 2011 the government decided, further to an investigation of the Ministry of Communications and Ministry of Finance, together with the Second Authority and the Council, to formulate legislative amendments to anchor the expansion of the DTT setup, in two stages, within 24 months from the entry into force of these legislative amendments. Pursuant to the decision, and subject to the terms to be determined in the legislation, a radio channel containing regional and national radio channels, an "Educational 23" channel, the designated Russian-language channel, the designated Israeli music and Mediterranean music channel, an additional channel of the broadcasting authority which will broadcast using HD technology, a designated Arabic channel, a designated news channel and a dedicated heritage channel will be added to the setup in two stages. Any of the above channels may be added upon request with payment of a distribution charge. In accordance with the decision, the Minister of Communications may, in consultation with the Minister of Finance, the Council and the Second Authority, add more channels to the setup in accordance with applications from the channels and the regulations which will be determined in this matter. The government also decided that in January 2014, the ownership and operation of the DTT setup would be transferred from the Second Authority to another government or public body which does not supervise television broadcasts. An increase or variation in the number of channels to be distributed via this setup is likely, in the opinion of the Company, to increase the capability of the setup to offer substitutes for DBS's services and this is liable to cause material harm to its revenues.

B. In January 2011, the Company and Bezeq signed agreements according to which the Company will market Bezeq's telephony and internet infrastructure services, including as part of the service bundle, and Bezeq will market the Company's television services, including as part of the service bundle. The agreements were approved as a transaction in which a controlling shareholder has a personal interest. At the reporting date, the parties have not yet implemented the provisions of these agreements.

C. In January 2011, the Knesset Finance Committee approved an amendment to the Royalties (Satellite Broadcasts) Regulations so that in 2011 and 2012 the rate of royalties would be 1.75% and 2.5% of taxable income respectively, and would revert to 1% commencing 2013 or on the date when the terms laid down in the Regulations are met.

D. The Company is examining the possibility of expanding the debentures series (Series B) by issuing additional debentures for NIS 120 million, according to orders it received from institutions, subject to the approval of the banks and confirmation from the Rating Agency that the debentures will not be downgraded as a result. Fifty percent of the consideration from the issue is designated for early repayment of part of the Company's long-term bank loans. At the reporting date, the expansion of the series has not yet been approved.

E. On January 9, 2011, a motion for certification of a class action against the Company was filed at the Tel Aviv-Jaffa district court for NIS 50 million. The plaintiff alleges that the Company violated its obligation, inter alia, pursuant to the Communications (Telecommunications and Broadcasts) Law 5742-1982 and the Regulations for Restricting Volume during Commercials, Promos and Other Broadcasts, 5769-2009. The plaintiff contends that these breaches are reflected in the volume in broadcasts of the Company's commercials, promos and service announcements**.** The amount of the claim for each subscriber is NIS 100, and the plaintiff estimates that the group he seeks to represent includes approximately 500,000 subscribers. The Company has not yet responded to the motion for certification.

F. On March 1, 2011, the Company received a rating of ilA- for additional debentures of NIS 120 million par value, to be issued in expansion of Series B.

NOTE 33 – APPOINTMENT OF THE CHAIRMAN OF THE BOARD FOR THE FINANCIAL STATEMENTS APPROVAL MEETING

On the date of approval of the financial statements, the Company's board of directors does not have an incumbent chairman. Consequently, on March 7, 2011, the Company's board of directors authorized Mr. David Efrati, a director in the Company, to serve as chairman of the board of directors' meeting convened to approve and to sign the Company's financial statements as at December 31, 2010.

Regulation 9D – Report on the Liabilities of the Reporting Corporation and Companies that are Consolidated or Proportionately Consolidated in the Financial Statements:

1. The liabilities of the reporting corporation, as a separate legal entity:

   A. Liability certificates issued by the reporting corporation, held by the public, except for the liability certificates held by the parent company of the reporting corporation, a controlling shareholder therein, corporations under their control or under the control of the reporting corporation:

	Principal payments - NIS CPI-linked	Gross interest payments (pre-tax)
	NIS millions	NIS millions
First year	644	110
Second year	294	78
Third year	294	62
Fourth year	294	47
Fifth year and thereafter	587	47
Total	2,113	344

   B. Liability certificates and non-banking credit as follows:

   Liability certificates issued by the reporting company, which are not held by the public, except for the liability certificates held by the parent company of the reporting corporation, a controlling shareholder therein, corporations under their control or under the control of the reporting corporation.

	Principal payments - NIS CPI-linked	Gross interest payments (pre-tax)
	NIS millions	NIS millions
First year	102	6
Second year	102	6

   C. Credit received by the reporting corporation from the Bank of Israel

	Principal payments - NIS CPI-linked	Gross interest payments (pre-tax)
	NIS millions	NIS millions
First year	-	112
Second year	154	111
Third year	475	105
Fourth year	475	85
Fifth year and thereafter	1,496	123
Total	2,600	536

2. For liabilities of the subsidiaries and the proportionately-controlled subsidiaries of the reporting corporation, except for companies that are themselves a reporting corporation, the following will be specified:

A. Balances of credit and liabilities, as follows:

1. Credit received by the subsidiaries from the Bank of Israel

2. Total liability certificates issued by the subsidiaries

	Principal payments - CPI-linked (NIS)	Principal payments CPI-linked (NIS)	Gross interest payments (pre-tax)
	NIS millions	NIS millions	NIS millions
First year	179	7	36
Second year	171	11	28
Third year	169	11	20
Fourth year	169	11	11
Fifth year and thereafter	87	37	5
Total	775	77	100

3. For credit from Group companies or liability certificates held by Group companies, the following will be specified:

A. Credit received by the reporting corporation from companies that are consolidated or proportionately consolidated in its financial statements, and the balance of liability certificates issued by the reporting corporation held by them.

	Principal payments - NIS CPI-linked	Gross interest payments (pre-tax)
	NIS millions	NIS millions
First year	374	58
Second year	172	45
Third year	172	36
Fourth year	171	27
Fifth year and thereafter	343	27
Total	1,232	193

BEZEQ THE ISRAEL TELECOMMUNICATION CORP. LIMITED

SEPARATE FINANCIAL INFORMATION

FOR THE YEAR ENDED DECEMBER 31, 2010

The information contained in these financial statements constitutes a translation of the financial statements 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.

Separate Financial Data as at December 31, 2010

Contents

Somekh Chaikin
8 Hartum Street, Har Hotzvim
PO Box 212, Jerusalem 91001
Israel

Telephone 972 2 531 2000
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To:
The Shareholders of “Bezeq” The Israeli Telecommunication Corp. Limited

Dear Sirs,

Subject: Special auditors’ report on separate financial data according to Regulation 9C of the Securities Regulations (Periodic and Immediate Reports) - 1970

We have audited the separate financial data presented in accordance with Regulation 9C of the Securities Regulations (Periodic and Immediate Reports) - 1970 of “Bezeq” The Israeli Telecommunication Corp. Limited (hereinafter - the Company) as of December 31, 2010 and 2009 and for each of the three years, the last of which ended on December 31, 2010, which are included in the Company’s periodic report. The separate financial data are the responsibility of the Company’s Board of Directors and of its Management. Our responsibility is to express an opinion on the separate financial data based on our audits.

We did not audit the financial statements of equity accounted investees the investment in which amounted to NIS 228 million as of December 31 2010, and the Company’s share in their profits amounted to NIS 6 million for the year ended on such date. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us, and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in Israel. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the separate financial data. An audit also includes assessing the accounting principles that were used in preparing the separate financial data and the significant estimates made by the Board of Directors and by Management, as well as evaluating the separate financial data presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the abovementioned other auditors, the separate financial data has been prepared, in all material respects, in accordance with Regulation 9C of the Securities Regulations (Periodic and Immediate Reports) - 1970.

Without qualifying our opinion, we draw attention to the claims made against the Company for which the exposure cannot yet be assessed or calculated, as described in Note 10.

Somekh Chaikin
Certified Public Accountants

March 7, 2011

Information on Financial Position as at December 31

	Note	2010 NIS millions	2009 NIS millions
Assets			
Cash and cash equivalents	3	**198**	360
Investments, including derivatives	4A	**178**	10
Trade receivables		**771**	845
Other receivables		**329**	555
Inventory		**15**	9
Assets classified as held for sale		**29**	40
Total current assets		**1,520**	1,819
Investments, including derivatives	4A	**96**	100
Trade and other receivables		**206**	102
Property, plant and equipment	6	**4,006**	* 3,771
Intangible assets		**276**	193
Investments in investees		**6,939**	6,566
Deferred tax assets	5	**248**	383
Total non-current assets		**11,771**	11,115
Total assets		**13,291**	12,934

	Note	2010 NIS millions	2009 NIS millions
Liabilities			
Debentures, loans and borrowings	4C	**941**	685
Trade payables	4B	**306**	263
Other payables, including derivatives	4B	**569**	537
Loans from subsidiaries	4C,9	**203**	250
Current tax liabilities		**229**	86
Deferred income		**17**	19
Provisions	10	**230**	279
Employee benefits		**233**	469
Total current liabilities		**2,728**	2,588
Debentures	4C	**2,373**	3,166
Bank loans	4C	**2,600**	383
Employee benefits		**259**	247
Deferred income and others		**4**	6
Total non-current liabilities		**5,236**	3,802
Total liabilities		**7,964**	6,390
Equity			
Share capital		**6,213**	6,187
Share premium		**378**	275
Reserves		**526**	595
Deficit		**(1,790)**	(513)
Total equity		**5,327**	6,544
Total equity and liabilities		**13,291**	12,934

Shaul Elovitch Chairman of the Board of Directors	**Avi Gabbay** CEO	**Alan Gelman** Deputy CEO and CFO

Date of approval of the financial statements: March 7, 2011

* Retrospective application by restatement, see Note 2C

The attached notes are an integral part of the separate financial information

Information on Income for the Year ended December 31

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Revenue	7	**5,263**	5,303	5,498
Costs and expenses				
Depreciation and amortization		**690**	794	852
Salaries		**1,079**	1,094	1,202
General and operating expenses	8	**1,609**	1,690	1,873
Other operating expenses (income), net		**(158)**	202	96
		3,220	3,780	4,023
Operating profit		**2,043**	1,523	1,475
Financing expenses				
Financing expenses		**282**	295	361
Financing income		**(192)**	(310)	(236)
Financing expenses (income), net		**90**	(15)	125
Profit after finance expenses, net		**1,953**	1,538	1,350
Share in profits of investees, net		**1,017**	958	677
Profit before income tax		**2,970**	2,496	2,027
Income tax	5	**527**	431	400
Income after taxes on income		**2,443**	2,065	1,627
Profit from deconsolidation of a subsidiary		**-**	1,538	-
Profit for the year		**2,443**	3,603	1,627

The attached notes are an integral part of the separate financial information

Information on Comprehensive Income for the Year Ended December 31

	2010 NIS millions	2009 NIS millions	2008 NIS millions
Profit for the year	**2,443**	3,603	1,627
Items of other comprehensive income			
Other comprehensive income (loss) for the year, net of tax	**8**	(11)	(7)
Other comprehensive income (loss) for the year, net of tax, in respect of investees	**5**	-	(3)
Other comprehensive income (loss) for the year, net of tax	**13**	(11)	(10)
Total comprehensive income for the year	**2,456**	3,592	1,617

The attached notes are an integral part of the separate financial information

Information on Cash Flows for the Year Ended December 31

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Cash flows from operating activities				
Profit for the year		**2,443**	3,603	1,627
Adjustments:				
Depreciation	6	**618**	* 715	*716
Amortization of intangible assets		**72**	79	136
Profit from deconsolidation of a subsidiary		**-**	(1,538)	-
Share in the (profits) losses of equity-accounted investees		**(1,017)**	(958)	(677)
Financing expenses, net		**69**	(44)	86
Capital gain, net		**(171)**	(64)	(68)
Share-based payment transactions		**26**	25	38
Income tax expenses	5	**527**	431	400
Change in inventory		**(6)**	1	9
Change in trade and other receivables		**29**	26	90
Change in trade and other payables	4	**55**	1	(18)
Change in provisions		**(45)**	25	(34)
Change in employee benefits		**(213)**	118	(306)
Expense (income) for derivatives, net		**11**	-	-
Net cash flows from operating activities for transactions with investees	9	**2**	2	16
Net income tax paid		**(260)**	(202)	(335)
Net cash from operating activities		**2,140**	2,220	1,680
Cash flows from investing activities				
Investment in intangible assets		**(156)**	(133)	(98)
Proceeds from sale of property, plant and equipment		**132**	86	144
Change in current investments, net		**-**	6	319
Purchase of property, plant and equipment	6	**(876)**	(720)	(518)
Proceeds from disposal of investments and long-term loans		**-**	46	17
Interest received		**8**	25	34
Acquisition of a subsidiary from an investee	9	**(196)**	-	-
Net cash flows from investment activities for transactions with investees)	9	**1,097**	578	302
Net cash from (used for) investment activities		**9**	(112)	200

* Retrospective application by restatement, see Note 2C

The attached notes are an integral part of the separate financial information

Information on Cash Flows for the Year Ended December 31 (Contd.)

	Note	2010 NIS millions	2009 NIS millions	2008 NIS millions
Cash flow from financing activities				
Bank loans received	4	**2,600**	400	-
Repayment of bank loans		**(400)**	-	-
Repayment of debentures	4	**(567)**	(556)	(593)
Dividend paid		**(3,733)**	(1,941)	(1,514)
Interest paid		**(196)**	(167)	(183)
Net proceeds for derivatives		**10**	44	52
Proceeds from exercise of options		**26**	129	-
Net cash from financing activities (used for activities) for transactions with investees	9	**(51)**	250	-
Net cash used for financing activities		**(2,311)**	(1,841)	(2,238)
Increase (decrease) in cash and cash equivalents		**(162)**	267	(358)
Cash and cash equivalents at January 1		**360**	93	451
Cash and cash equivalents at end of year	3	**198**	360	93

The attached notes are an integral part of the separate financial information

NOTE 1 – GENERAL

Below is financial information from the Group's consolidated financial statements as at December 31, 2010 ("the consolidated statements"), published as part of the periodic reports, attributable to the Company itself ("the separate financial information"), presented according to Article 9C ("the Article") and the Tenth Addendum to the Securities Regulations (Periodic and Interim Reports), 5730-1970 ("the Tenth Addendum"), in respect of the separate financial information of the corporation.

In this separate financial information -

"The Company": Bezeq The Israel Telecommunication Corporation Ltd.

"Associate", "the Group", "Investee", "Interested Party": as defined in the consolidated financial statements of the Group for 2010 ("the consolidated statements").

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES APPLIED IN THE SEPARATE FINANCIAL INFORMATION

The accounting policies set out in the consolidated financial statements have been applied consistently to all periods presented in the separate financial information, including the method for classifying the financial information in the consolidated statements, with the required changes as set out below.

A. Presentation of financial information

(1) Information on financial position
This information includes information about the amounts of assets and liabilities in the consolidated statements attributable to the Company itself (other than for investees), with a description of the types of assets and liabilities. The information also includes information about the net amount, based on the consolidated statements, attributable to the shareholders of the Company itself, of the assets less the liabilities, for investees, including goodwill.

(2) Information on comprehensive income
This information includes information about the amounts of income and expenses in the consolidated statements, with a breakdown of profit or loss and other comprehensive income, attributable to the Company itself (other than for investees), with a description of the types of income and expenses. The information also includes information about the net amount, based on the consolidated statements, attributable to the shareholders of the Company itself, of total income less total expenses for the operating results of investees, including impairment of goodwill, impairment or derecognition of an investment in an associate, and impairment or derecognition of an investment in an equity-accounted jointly-controlled company.

(3) Information on cash flows
This information includes details about the amounts of cash flows in the consolidated statements attributable to the Company itself (other than for investees), taken from the consolidated statement of cash flows, with a breakdown according to cash flow from operating activities, investment activities and financing, with details of their components. Cash flows for operating activities, investment activities and financing activities for transactions with investees are presented separately in net amounts, under the relevant activity, according to the nature of the transaction.

B. Transaction between the Company and investees

(1) Presentation
Reciprocal balances in the Group and income and expenses arising from reciprocal transactions, which were eliminated in the preparation of the consolidated statements, were presented separately from the balance for the investees and the profit for the investees, together with similar balances with third parties.

NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES APPLIED IN THE SEPARATE FINANCIAL INFORMATION (CONTD.)

B. Transaction between the Company and investees (contd.)

(2) Measurement

Transactions between the Company and its subsidiaries were measured according to recognition and measurement principles set out in International Financial Reporting Standards ("IFRS"), which provide accounting guidelines for this type of transaction with a third party.

C. Changes in accounting policies – Initial implementation of new accounting standards

Leases

As from January 1, 2010, the Company applies the amendment to IAS 17 – Leases: Classification of Leases of Land and Buildings ("the Amendment"). The Amendment eliminates the requirement to classify a lease of land as an operating lease when the title is not expected to pass to the lessee at the end of the lease term.

The Company has land lease agreements with the Israel Land Administration, which are accounted for as operating leases. Subsequent to adoption of the Amendment, the Company classified the lease of the land retrospectively as a finance lease. Accordingly, the land is stated as property, plant and equipment in the information of financial position as at December 31, 2010, in the amount of NIS 125 million.

NOTE 3 – CASH AND CASH EQUIVALENTS

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
In NIS	**195**	357
Linked to foreign currency	**3**	3
Total cash and cash equivalents	**198**	360

NOTE 4 - FINANCIAL INSTRUMENTS

A. Investments, including derivatives

(1) Segmentation by investment classification

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Current investments		
Current maturities for the loan to a subsidiary	**178**	-
Derivatives	**-**	10
	178	10
Non-current investments		
Bank deposit for loans to employees	**83**	83
Investments in mutual funds	**3**	7
Derivatives	**10**	10
	96	100
	274	110

(2) Analysis of projected realization dates

	2011	2012	To be determined	Total
	NIS millions	NIS millions	NIS millions	NIS millions
Current maturities for the loan to a subsidiary	**178**	**-**	**-**	**178**
Investments in shares and options	**-**	**-**	**3**	**3**
Deposit for providing loans to employees	**-**	**-**	**83**	**83**
Derivatives	**-**	**10**	**-**	**10**
	178	**10**	**86**	**274**

Notes to the separate financial information as at December 31, 2010

NOTE 4 - FINANCIAL INSTRUMENTS (CONTD.)

B. Trade and other payables

	December 31, 2010			
	Unlinked	Linked to the CPI	Dollar or dollar linked	Total
	NIS millions	NIS millions	NIS millions	NIS millions
Trade payables	**282**	**-**	**24**	**306**
Other payables	**455**	**104**	**10**	**569**
	737	**104**	**34**	**875**

	December 31, 2009			
	Unlinked	Linked to the CPI	Dollar or dollar linked	Total
	NIS millions	NIS millions	NIS millions	NIS millions
Trade payables	236	-	27	263
Other payables	426	111	-	537
	662	111	27	800

C. Debentures and loans

(1) Composition

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Current liabilities		
Current maturities of debentures	**941**	668
Current maturities of bank loans	**-**	17
Loans from investees	**203**	250
	1,144	935
Non-current liabilities		
Debentures	**2,373**	3,166
Bank loans	**2,600**	383
	4,973	3,549
	6,117	4,484

NOTE 4 - FINANCIAL INSTRUMENTS (CONTD.)

C. Debentures and loans (contd.)

(2) Debt repayment terms and schedule

				December 31, 2010		December 31, 2009	
	Currency	Nominal interest rate %	Redemption year	Par value NIS millions	Carrying amount NIS millions	Par value NIS millions	Carrying amount NIS millions
Loans from banks:							
Unlinked – variable interest	NIS	Prime + 0.33	2011-2017	**1,300**	**1,300**	400	400
Unlinked – fixed interest	NIS	5-5.6	2011-2017	**1,300**	**1,300**		
Loans from investees							
Linked	NIS	4	2011	**200**	**203**	250	250
					2,803		650
Debentures issued to the public:							
Linked to the CPI	NIS	4.8-5.3	2011-2016	**2,687**	**3,212**	2,987	3,510
Debentures issued to financial institutions and others:							
Linked to the CPI	NIS	4.8-5.95	2011-2014	**81**	**102**	273	324
					3,314		3,834
Total interest-bearing liabilities					**6,117**		4,484

NOTE 4 - FINANCIAL INSTRUMENTS (CONTD.)

D. Liquidity risk

Below are the contractual repayment dates of financial liabilities, including interest payments.

	December 31, 2010						
	Carrying amount	Contractual cash flow	6 months or less	6-12 months	1-2 years	3-5 years	More than five years
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Non-derivative financial liabilities							
Trade payables	**306**	**306**	**306**	**-**	**-**	**-**	**-**
Other payables	**569**	**569**	**562**	**7**	**-**	**-**	**-**
Loans from subsidiaries	**203**	**203**	**203**	**-**	**-**	**-**	**-**
Bank loans	**2,600**	**3,122**	**42**	**56**	**265**	**1,679**	**1,080**
Debentures issued to the public	**3,212**	**3,580**	**885**	**-**	**588**	**1,617**	**490**
Debentures issued to financial and other institutions	**102**	**88**	***88**	**-**	**-**	**-**	**-**
	6,992	**7,868**	**2,086**	**63**	**853**	**3,296**	**1,570**

* Including debentures of the Company amounting to NIS 77 million, stated in the financial statements as short term due to non-compliance with financial covenants.

NOTE 4 - FINANCIAL INSTRUMENTS (CONTD.)

D. Liquidity risk (contd.)

	December 31, 2009						
	Carrying amount	Contractual cash flow	6 months or less	6-12 months	1-2 years	3-5 years	More than five years
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Non-derivative financial liabilities							
Trade payables	263	263	263	-	-	-	-
Other payables	537	537	528	9	-	-	-
Loans from subsidiaries	250	250	250	-	-	-	-
Bank loans	400	432	4	24	84	320	-
Debentures issued to the public	3,510	4,011	417	-	959	1,653	982
Debentures issued to financial and other institutions	324	342	*342	-	-	-	-
	5,284	5,835	1,804	33	1,043	1,973	982

* Including debentures of the Company amounting to NIS 94 million, stated in the financial statements as short term due to non-compliance with financial covenants.

NOTE 4 - FINANCIAL INSTRUMENTS (CONTD.)

E. Currency and CPI risks

Company exposure to CPI and foreign currency risks for derivative financial instruments:

	December 31, 2010				
	Currency/ linkage receivable	Currency/ linkage payable	Expiration date	Par value (currency)	Fair value
				Millions	NIS millions
Instruments not used for hedging:					
CPI forward contract	CPI	CPI	2011-2012	350	10

	December 31, 2009				
	Currency/ linkage receivable	Currency/ linkage payable	Expiration date	Par value (currency)	Fair value
				Millions	NIS millions
Instruments not used for hedging:					
CPI forward contract	CPI	CPI	2010-2012	400	19

Notes to the separate financial information as at December 31, 2010

NOTE 5 – INCOME TAX

A. General

	Year ended December 31		
	2010	**2009**	**2008**
	NIS millions	**NIS millions**	**NIS millions**
Current tax expense			
For the current period	**396**	301	292
Adjustments for prior years, net	**-**	(30)	-
	396	271	292
Deferred tax expense			
Creation and reversal of temporary differences	**131**	120	108
Effect of change in tax rates	**-**	40	-
	131	160	108
Income tax expenses	**527**	431	400

B. Deferred tax assets and liabilities recognized

Deferred tax assets and liabilities are attributable to the following items:

	December 31	
	2010	**2009**
	NIS millions	**NIS millions**
Employee benefit plan	**245**	318
Share-based payments	**16**	27
Provisions	**22**	30
Property, plant and equipment	**(42)**	* -
Others	**7**	8
	248	383

* Less than NIS 500,000

Notes to the separate financial information as at December 31, 2010

NOTE 5 - INCOME TAX (CONTD.)

C. Changes in temporary differences during the year

	Balance at January 1 2009	Recognized in profit or loss	Recognized in equity	Balance at December 31 2009	Recognized in profit or loss	Recognized in equity	Balance at December 31 2010
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Employee benefits	345	(30)	3	318	**(70)**	**(3)**	**245**
Share-based payments	118	(91)	-	27	**(11)**	**-**	**16**
Provisions	43	(13)	-	30	**(8)**	**-**	**22**
Property, plant and equipment	22	(22)	-	-	**(42)**	**-**	**(42)**
Others	12	(4)	-	8	**-**	**(1)**	**7**
	540	(160)	3	383	**(131)**	**(4)**	**248**

NOTE 6 – PROPERTY, PLANT AND EQUIPMENT

	2010	2009 *
	NIS millions	NIS millions
Cost or deemed cost		
Balance at January 1	**16,818**	16,961
Additions	**885**	710
Disposals	**(926)**	(843)
Transfer to assets held for sale	**40**	(10)
Balance at December 31	**16,817**	16,818
Depreciation and loss from impairment of assets		
Balance at January 1	**13,047**	13,142
Depreciation for the year	**618**	715
Disposals	**(884)**	(799)
Transfer to assets held for sale	**30**	(11)
Balance at December 31	**12,811**	13,047
Carrying amount		
At January 1	**3,771**	3,819
At December 31	**4,006**	3,771

* Retrospective application by restatement, see Note 2(I)

NOTE 7 – REVENUE

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Fixed line telephony	**3,160**	3,333	3,572
Internet - infrastructure	**977**	863	790
Transmission and data communications	**882**	851	811
Other services	**244**	256	325
	5,263	5,303	5,498

NOTE 8 – OPERATING AND GENERAL EXPENSES

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Cellular telephone expenses	**801**	823	894
General expenses	**250**	266	259
Materials and spare parts	**88**	80	99
Building maintenance	**240**	278	293
Services and maintenance by sub-contractors	**76**	96	113
Vehicle maintenance expenses	**101**	96	126
Royalties to the State of Israel	**31**	18	57
Collection fees and sundry	**22**	33	32
	1,609	1,690	1,873

NOTE 9 - MATERIAL AGREEMENTS AND TRANSACTIONS WITH INVESTEES

List of entities held directly by the Company:

- Pelephone Communications Ltd. ("Pelephone")
- Bezeq International Ltd. (“Bezeq International”)
- Bezeq Online Ltd. (“Bezeq Online”)
- Bezeq Zahav (Holdings) Ltd. (“Bezeq Zahav”)
- Stage One Venture Capital Fund (Israel) LP ("Stage One")
- DBS Satellite Services (1998) Ltd. ("DBS")
- Walla! Communications Ltd. (“Walla”)

A. Financial guarantees

(1) The Company provided a guarantee in favor of banks for credit of up to NIS 70 million provided to Bezeq International: a guarantee of NIS 60 million provided in 1996 and two other guarantees of NIS 10 million in favor of Bezeq Call Communications Ltd., which merged with Bezeq International.

(2) For information about the guarantees and liens provided by the Company to various entities in respect of DBS, see Note 20 to the consolidated financial statements: Securities, Liens and Guarantees.

B. Loans

Loans from investees

(1) On October 4, 2009, the Company received a loan of NIS 280 million from Pelephone (according to the framework agreement between the two companies).

The loan was linked to the CPI and bore annual interest at a rate of 4%, repayable by January 4, 2010. At December 31, 2009, the unpaid principal was NIS 180 million, which was subsequently repaid on its due date.

NOTE 9 - MATERIAL AGREEMENTS AND TRANSACTIONS WITH INVESTEES (CONTD.)

B. Loans (contd.)

Loans from investees (contd.)

(2) In 2010, the Company received loans from Pelephone (according to the framework agreement between the two companies). The loans are linked to the CPI, bear annual interest at a rate of 4% and are repayable as follows:

- A loan of NIS 90 million from May 31, 2010, repayable on January 6, 2011
- A loan of NIS 110 million from June 15, 2010, repayable on July 06, 2010
- A loan of NIS 110 million from October 03, 2010, repayable on January 6, 2011

(3) On October 4, 2009, the Company received a loan of NIS 70 million from Bezeq International (according to the framework agreement between the parties). The loan was linked to the CPI, bore annual interest at a rate of 4%, and was repayable by January 4, 2010. At December 31, 2009, the unpaid principal amounted to NIS 70 million, which was subsequently repaid on its due date.

(4) In 2004, Bezeq Zahav acquired Debentures (Series 5) of the Company. At December 31, 2010, the par value of the debentures held by Bezeq Zahav amounted to 880,100,000. The debentures are repayable in six equal annual installments in each of the years 2011 to 2016. The annual interest rate for these debentures is 5.3%. The acquisition was made by taking a loan from the Company, at the same terms as those of the debentures.

Loans to investees

(1) There is a framework agreement between the Company and Bezeq Online from December 9, 2001. According to the agreement, the Company will provide a short-term loan to Bezeq Online from time to time. The loan bears current interest at the Bank of Israel rate, plus 0.5%. At December 31, 2010, the balance of the loan is NIS 5 million (at December 31, 2009, NIS 10.5 million).

(2) On March 21, 2010, the Company provided a loan of NIS 45 million to Bezeq International, subject to the terms of the framework loan agreement between the two companies. The loan was linked to the CPI, bore annual interest at a rate of 4% and was repaid in four equal monthly payments (principal and interest), commencing on June 1, 2010. The loan was repaid on its due date.

(3) For details of the loan provided by the Company to DBS, see Note 13 to the consolidated statements: Investees.

(4) For details of the loan provided by the Company to Bezeq Zahav in respect of Debentures (Series 5), see section B(3) above.

C. Service agreements

The Company and its investees, as communications providers, are parties to agreements and arrangements for providing and receiving various communication services, as follows:

Pelephone

Transmission agreement, interconnect arrangements, agreements regulating communication services provided by the two companies jointly, agreements for acquisition of communication equipment and lease agreements (mainly for communication facilities).

NOTE 9 - MATERIAL AGREEMENTS AND TRANSACTIONS WITH INVESTEES (CONTD.)

C. Service agreements (contd.)

Bezeq International

Transmission agreement, interconnect arrangements, billing agreements, international and domestic communication services, ADSL agreement (for regulating the connection between the Company's infrastructure and Bezeq International's servers) agreements regulating communication services provided by the two companies jointly, maintenance of communication equipment, dealer agreements, agreements for acquisition of communication equipment and lease agreements (mainly for communication facilities).

Bezeq Online

Agreements for maintenance of equipment, voice mail service agreements.

DBS

Dealer agreements and communication equipment maintenance agreements

Walla

Agreement for billing through Walla's website.
The agreement terms for these services were determined on the basis of standard market rates for these types of services.

D. Other

In addition to these agreements for the supply of services, Pelephone and Bezeq International have a debt balance for their share in a manager compensation plan (as described in Note 27 to the consolidated financial statements: Share-based Payments). According to this plan, the Company has reached an agreement with Pelephone and Bezeq International according to which, if the options are exercised, the Company will receive from these companies, immediately after exercise, a sum equal to the value of the benefit charged to the employees for tax purposes ("the yield part").

NOTE 9 - MATERIAL AGREEMENTS AND TRANSACTIONS WITH INVESTEES (CONTD.)

E. Details of the scope of the transactions and carrying amount in the Company's financial statements for these transactions (except for loans described in section B above).

	Year ended December 31		
	2010	2009	2008
	NIS millions	NIS millions	NIS millions
Transactions			
Revenue			
Pelephone	**160**	149	138
Bezeq International	**110**	103	116
DBS	**1**	10	64
Others	**2**	2	1
Total	**273**	264	319
Expenses			
Pelephone	**241**	233	254
Bezeq International	**11**	3	17
DBS	**5**	1	4
Others	**6**	-	5
Total	**263**	237	280

	December 31, 2010	December 31, 2009
	NIS millions	NIS millions
Balance		
Pelephone	**(14)**	(1)
Bezeq International	**9**	(3)
DBS	**47**	52
Others	**3**	(1)
Total	**45**	47

For further information, see Note 30 to the financial statements, Transactions with Interested and Related Parties.

NOTE 9 - SUBSTANTIAL AGREEMENTS AND TRANSACTIONS WITH INVESTEES (CONTD.)

F. Dividends and investments

(1) On January 4, 2010, Pelephone paid the Company a dividend of NIS 375 million, in respect of dividends declared in 2009 (of NIS 425 million).

(2) In 2010, Pelephone declared distribution of a dividend of NIS 625 million, of which NIS 200 million was paid to the Company on May 2, 2010, NIS 210 million on September 3, 2010 and the remaining NIS 215 million was paid on January 6, 2011.

(3) On January 4, 2010, Bezeq International paid the Company a dividend of NIS 90 million, for the dividend declared in 2009 (in the amount of NIS 210 million).

(4) In 2010, Bezeq International declared distribution of a dividend of NIS 216 million, of which NIS 196 million was paid to the Company on September 21, 2010 and NIS 20 million was paid on November 30, 2010.

(5) In December 2010, the Company received its share in the profits of Stage One, amounting to NIS 10 million. On the other hand, the Company provided Stage One with an amount of NIS 8 million.

(6) On September 21, 2010, after receiving approval from the Antitrust Commissioner, the Company acquired from Bezeq International all the shares of Walla held by Bezeq International, representing 71.76% of the issued and paid up share capital of Walla, for NIS 196 million. For further details, see Note 5 to the consolidated financial statements: Acquisition of Subsidiaries.

For further information about investees, see Note 13 to the consolidated financial statements: Investees.

NOTE 10 – CONTINGENT LIABILITIES

In the course of regular business, legal claims were filed or are pending against the Company ("hereinafter in this section: "legal claims").

The financial statements of the Company include provisions of NIS 230 million for the claims.
The additional exposure beyond these provisions for the legal claims amounts to NIS 4.1 million.
There are also claims amounting to NIS 259 million, which at this stage cannot be assessed, as well as other claims for which the Company's additional exposure exceeds the aforesaid, as the exact amount of the claim is not stated in the claim.

In addition, subsequent to the reporting date, customers of the Company filed a number of claims against the Company, amounting to NIS 540 million.

For further information about contingent liabilities, see Note 18 to the consolidated financial statements: Contingent Liabilities.

Chapter D - Additional Information about the Company

1. Standard 10A: Summary of the Company's consolidated statements of income for the year ended December 31, 2010 (in NIS millions)

The quarterly statements were drafted in compliance with the International Financial Reporting Standards (IFRS)

	Q1 2010	Q2 2010	Q3 2010	Q4 2010	2010	2009
Revenue	2,915	2,981	3,033	3,058	11,987	11,519
Costs and expenses	2,041	1,991	2,054	2,157	8,243	8,547
Operating profit	874	990	979	901	3,744	2,972
Finance income (expenses), net	22	(35)	(74)	(22)	(109)	31
Earnings before Group's equity in affiliates	896	955	905	879	3,635	3,003
Group's share in earnings (losses) of affiliates	(23)	(86)	(71)	(81)	(261)	(34)
Profit before income tax	873	869	834	798	3,374	2,969
Income tax	231	231	246	224	932	807
Earnings for the period from continuing operations	642	638	588	574	2,442	2,162
Earnings (losses) from discontinued operations	-	-	-	-	-	1,379
Profit for the period	642	638	588	574	2,442	3,541
Other comprehensive income (loss), net for the period From tax	(1)	1	3	10	13	(11)
Total comprehensive income for the period	641	639	591	584	2,455	3,530
Attributed to:						
Shareholders of the Company	641	639	591	585	2,456	3,592
Non-controlling interests	-	-	-	(1)	(1)	(62)
Total comprehensive income for the period	641	639	591	584	2,455	3,530
Earnings per share Profit from continuing operations	0.24	0.24	0.22	0.21	0.91	0.82
Profit from discontinued operations	-	-	-	-	-	0.55
	0.24	0.24	0.22	0.21	0.91	1.37
Diluted profit per share (in NIS) Profit from continuing operations	0.24	0.24	0.22	0.20	0.90	0.8
Profit from discontinued operations	-	-	-	-	-	0.54
	0.24	0.24	0.22	0.20	0.90	1.34

2. Standard 10C: Use of proceeds for the securities with special reference to the application of proceeds based on the prospectus

No issue has been made based on a prospectus.

3. Standard 11: Breakdown of material investments in subsidiaries and related companies as of the date of the financial statements

Company	Name of holder	Class of share	Number of shares	Total par value	Rate of holding in the issued equity and in the voting rights	Rate of holdings in rights to appoint directors	Company's separate balance sheet value
Pelephone Communications Ltd.	The Company	Ordinary NIS 1 shares	302,460,000	302,460,000	100%	100%	3,983
Bezeq International Ltd.	The Company	Ordinary NIS 0.1 shares	1,136,990,000	113,699,000	100%	100%	743
D.B.S. Satellite Services (1998) Ltd.[1]	The Company	Ordinary NIS 1 shares	14,881	14,881	49.78%	45.45% [2]	1,084
Bezeq Online Ltd.[3]	The Company	Ordinary NIS 1 shares	1,070,000	1,070,000	100%	100%	30
Bezeq Zahav Holdings Ltd.	The Company	Ordinary NIS 1 shares	999,999	999,999	100%	100%	1,049
Walla! Communications Ltd.[4]	Bezeq International	Ordinary NIS 1 shares	32,644,997	32,644,997	71.55% [5]	71.55%	188

1 The investment in D.B.S. includes the investment of NIS 1,351 million .by way of loans; of which NIS 44 million are loans linked to the CPI, NIS 172 million are loans linked to the CPI with the addition of 5.5%, and NIS 1,135 million in loans linked to the CPI with the addition of 11% interest.

2 Pursuant to the articles of association of DBS, based on the current holdings in DBS, the Company is entitled to appoint up to 5 of the 11 directors that the shareholders in DBS are entitled to appoint. In addition, according to DBS articles of association, the voting rights of each board member will be equivalent to the total voting rights of the shareholder who appointed the director divided by the number of directors appointed by that shareholder so that the voting rights of the directors appointed by the Company will be 49.7% of the voting rights on the board of directors of DBS.

3 Loans were extended to the subsidiary, Bezeq Zahav (Holdings) Ltd. for financing the acquisition of debentures Series 4 and 5 of the Company.

4 Walla share price on the Tel Aviv Stock Exchange ("TASE") as at December 30, 2010 was NIS 0.502.2 (on December 31, 2010 there was no trading on the TASE). Walla has 2,389,704 employee options exercisable into 2,389,704 Walla shares based on Walla's financial statements at February 28, 2011).

5 67.99% Fully diluted

4. Standard 12: Material changes in investments in subsidiaries and related companies in the reporting period

Date of change	Nature of change	Company	Reported amounts In NIS millions
December 1, 2010	Employee options[6]	Pelephone	1
December 1, 2010	Employee options[7]	Bezeq International	2
December 1, 2010	Employee options[7]	D.B.S.	2
December 1, 2010	Dividend announcement	Pelephone	625
December 1, 2010	Dividend announcement	Bezeq International	216
April 25, 2010	Acquisition to gain control of Walla by Bezeq International [7]	Walla	89
August 29, 2010	Increase in the Company's holdings in Walla through Bezeq International.	Walla	14
August 29, 2010	Transaction with holders of non-controlling rights	Walla	(5)
September 21, 2010	Acquisition of the control in Walla through Bezeq International.	Walla	196
December 1, 2010	Reduced premium	Bezeq Zahav Holdings Ltd.	(7)
December 1, 2010	Revaluation	Bezeq Zahav Holdings Ltd.	23
December 1, 2010	Linkage differentials and interest	D.B.S.	158

5. Standard 13: Revenues of subsidiaries and related companies and the revenues of the Company from them as of the reporting date (in NIS millions)

Company	Profit (loss) for the period	Comprehensive income (loss) for the period	Dividend	Management fees	Interest income
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Pelephone	1,033	1,036	625		-
Bezeq International	253	253	216		0.6
D.B.S.	(314)	(315)	0		137
Bezeq Online Ltd.	4	4	0		0.2
Bezeq Zahav Holdings Ltd.	0	0	0		47
Walla! *	9	9	0		-

*** The presented results are for the entire period 2010, Walla was consolidated as of April 25, 2010 only.**

6 For further particulars of the options plan see section 2.9.7.A of Chapter A of the periodic report (description of the Company's businesses).

7 For further particulars of the acquisition transaction for Wall shares see section 1.1.2 of Chapter A of the periodic report (description of the Company's businesses) and Note 5 to the financial statements.

6. Standard 20: Stock Exchange Trading – listed securities – dates and reasons for interruption of trading

26,189,422 ordinary NIS 1 par value shares of the Company were listed for trading in 2010, subsequent to exercised options from the employee options plan, under the outline dated March 25, 2007 and subsequent to exercise of options from the executive employee options plan dated December 25, 2007.

Dates and reasons for interruption of trade:

Start of interruption	End of interruption	Reason for interruption of trade
Dec 19, 2010 16:26	Dec 19, 2010 15:30	The Company's announcement (concerning preliminary discussion of reduction of capital)
Aug 2, 2010 14:50	Aug 2, 2010 15:35	Publication of Q2 statements
Mar 3, 2010 10:02	Mar 3, 2010 10:48	Publication of annual statements
Mar 3, 2010 09:43	Mar 3, 2010 10:02	TASE announcement (technical failure in publication of annual statements)

7. Standard 21: A Remuneration of interested parties and executive officers

Below is a breakdown of the remunerations for 2010, as recognized in the financial statements for the 2010, to each of the five highest-paid senior officers in the Company or in a corporation under its control, and which were paid to them in lieu of their service in the company or a corporation under its control, (employer's cost on annual basis):

Recipient			Remuneration (in NIS thousands)											Total (NIS thousands)
Name	Position	Employment basis	% of holding of Company's capital - shares	Salary[8]	Bonus[9]	Retention grant 2010	Share-based payment[10]	Management fees	Consultation fees	Commission	Interest	Rentals	Other	Total
Avraham Gabbay	CEO Bezeq	Full-time	0.001%	2,632	2,388	1,401	2,114	-	-	-	-	-	-	8,535
Gil Sharon	CEO, Pelephone Communications Ltd.	Full-time	-	2,631	2,329	1,401	2,114	-	-	-	-	-	-	8,475
Shlomo Rodav	Chairman Bezeq Board of Directors	Full-time	-	860	3,507	0	1,892	-	-	-	-	-	-	6,259
Alan Gelman	Bezeq Deputy CEO and CFO	Full-time	-	2,334	1,386	0	1,774	-	-	-	-	-	-	5,494
Yitzhak Benbenisti	CEO, Bezeq International Ltd.	Full-time	-	1,578	1,440	900	1,008	-	-	-	-	-	-	4,926

8 The salaries include the cost of salaries and the ancillary salary costs including benefits (as specified in the notes below) and social benefits, as well as changes in provisions set aside in the 2010 financial statements for severance compensation, prior notice and leave pay.

9 The bonus is for 2010 (at reporting date not yet paid to the senior officers) Furthermore, the bonus for 2010 for the chairman of the board of directors requires approval of the general meeting of the Company's shareholders. During the course of 2010 bonuses for 2009 were paid to these officers, the amounts of which are included in the parallel table in the Company's annual report for 2009 which was published on March 3, 2010..

10 The value based on Black & Scholes ("**B&S** value") on date of allocation. This amount is the relative value for share-based remuneration for options that were recognized in the financial statements for the reporting year.

Particulars pertaining to the terms of employment for the executive officers who appear in the foregoing table:

A. Avraham Gabbay

Employed by the Company as CEO, under a personal employment agreement dated July 19, 2007. The agreement is for an unlimited period, and it may be terminated by either party at any time and for any reason with 6 months prior notice. Under the agreement, the CEO is eligible to receive a gross monthly salary of NIS 155,000. This amount is linked to the CPI (in the reporting year the CEO's monthly salary amounted to NIS 162,000. In addition the CEO is eligible to receive ancillary benefits and social benefits such as company car, reimbursement of communications expenses, directors insurance, study fund, reimbursement of expenses incurred while fulfilling his position as well as generally accepted annual leave, sick and convalescence days.

On February 4, 2008, 5,250,000 options[11] were allotted to the CEO at an exercise price of NIS 5.50 (adjusted for distribution of dividend). The B&S value of all the options allotted to the CEO, as at allotment date, is NIS 14.25 million.

In December 2010 the Company's board of directors approved bonus goals for the Company's CEO, which were based on the Company's annual work schedule for 2010, and included two goals: (a) EBITDA goal for the Company (solo), which constitutes 80% of the bonus calculation; (b) parameters for the progress of the NGN project, which constitutes 20% of the bonus calculation. The Company CEO's bonus was limited to 80% of his annual salary for meeting 100% of the goals stipulated above, however the Company's Board of Directors is entitled to consider increasing the bonus to more than 80% of the annual salary, subject to the approval of the Company's audit committee.

Changes in remuneration instituted in the reporting year: On March 2, 2010 the Company's Board of Directors (upon receipt of the approval of the Company's compensations committee and audit committee) approved a bonus for the Company's CEO for 2009 in an amount of NIS 2,178,596. As aforesaid, this amount which is for 2009 is not included in the foregoing remunerations table.

Under the approved retention plan approved by the Company's institutions on December 31, 2009, the CEO of the Company was granted a retention grant equivalent to nine monthly salary payments without ancillary benefits (which was paid as a loan in January 2010). Furthermore, his options plan was amended so that if he should be dismissed (and not if he resigns) within one year (instead of 6 months), from the date of transfer of control in the Company, the vesting of the unvested balance of options will accelerate and the options will vest on the date of dismissal. For further information see the immediate report concerning an extraordinary transaction with an officer (adoption of the retention plan for senior managers in the Group) dated December 31, 2009, noted here by way of reference.

On December 30, 2010 the Company's board of directors approved a bonus plan for the Group's senior managers, including the Company's CEO, as of 2011. 1 The CEO's annual bonus plan would be amended so that he will be entitled to an annual bonus equivalent to 100% of his annual salary for compliance with goals set for him each year and equivalent to up to 125% of his annual salary for performance exceeding these goals. 2 The CEO was allotted 3,000,000 phantom options at exercise price of NIS 10.206. 3 The Company CEO's salary was amended and raised as of January 1, 2011 to NIS 175,000, linked to the CPI for December 2010. For further information see the immediate report amendment concerning an extraordinary transaction with an officer dated January 3, 2010, noted here by way of reference.

On March 7, 2011 the Company's board of directors (upon receipt of the approval of the Company's compensations committee and audit committee) approved the bonus for the Company's CEO for 2010 in an amount equivalent to 123% of the CEO's annual salary, in the amount of NIS 2,388,000.

[11] One-third of the options vest one calendar year after the grant date, another third of the options vest after two calendar years from the grant date and the final third of the options vest after three calendar years from the grant date. Shortly prior to the publication date of the financial statements, 2/3 of the options granted to the CEO have vested. The options are exercisable from the end of the vesting period of each tranche of options until five years have elapsed from the vesting date of the third tranche of options. The option remuneration is granted pursuant to the option plan for managers and senior officers (2007) and under a material private placement report for the company's CEO as reported in the Company's immediate report dated December 25, 2007

B. Gil Sharon

Employed as CEO of the subsidiary, Pelephone, under a personal employment agreement dated January 19, 2006. The agreement is for an unlimited period, and it may be terminated by either party at any time and for any reason with 12 months prior notice (by Pelephone) and 3 months prior notice (by Pelephone's CEO). His gross monthly salary is NIS 155,000, which amount is linked to the CPI (in the reporting year, his gross monthly salary amounted to NIS 162,000. In addition, Pelephone's CEO is eligible for ancillary and social benefits such as reimbursement of telephone expenses, company car, study fund, reimbursement of expenses, as well as generally accepted annual leave, sick and convalescence days.

On February 4, 2008, 5,250,000 options[12] were allotted to Pelephone's CEO at an exercise price of NIS 5.50 (adjusted for distribution of dividend). The B&S value of all the options allotted to Pelephone's CEO, as at allotment date, is NIS 14.25 million.

In December 2009, after receiving approval of the audit committee and board of directors of Pelephone, the Company's Board of Directors set an EBITDA goal (based on Pelephone's solo financial statements) for the CEO of Pelephone's annual bonus for 2010. The Pelephone CEO's bonus was limited to 80% of his annual salary for meeting 100% of the bonus goal, however the Company's Board of Directors is entitled to consider increasing the bonus to more than 80% of the annual salary, subject to the approval of the Company's audit committee and the board of directors and audit committee of Pelephone.

Changes in remuneration instituted in the reporting year: On March 2, 2010 the Company's Board of Directors approved a bonus for the CEO of Pelephone for 2009 in the amount of NIS 2,130,017. As aforesaid, this amount which is for 2009 is not included in the foregoing remunerations table.

Under the approved retention plan approved by the Company's institutions on December 31, 2009, the CEO of Bezeq International was granted a retention grant equivalent to nine monthly salary payments (which was paid as a loan in January 2010). Furthermore, his options plan was amended so that if he should be dismissed (and not if he resigns) within one year (instead of 6 months), from the date of transfer of control, the vesting of the unvested balance of options will accelerate and the options will vest on the date of dismissal.

On December 30, 2010 the Company's board of directors approved a bonus plan for the Group's senior managers, including the CEO of Pelephone, as of 2011. 1 The annual bonus plan for the CEO of Pelephone was amended so that he will be entitled to an annual bonus equivalent to 100% of his annual salary for compliance with goals set for him each year and equivalent to up to 125% of his annual salary for performance exceeding these goals. 2 The CEO of Pelephone was allotted 3,000,000 phantom options at exercise price of NIS 10.206. 3 The salary of the CEO of Pelephone was amended and raised as of January 1, 2011 to an amount of NIS 175,000, linked to the CPI for December 2010. For further information see the immediate report amendment concerning an extraordinary transaction with an officer dated January 3, 2010, noted here by way of reference.

On March 3, 2011 the Company's board of directors (upon receipt of the approval of the board of directors of Pelephone and of the Company's compensations committee and audit committee) approved the bonus for the CEO of Pelephone for 2010 in an amount equivalent to 120% of the annual salary of the CEO of Pelephone, in the amount of NIS 2,329,000.

C. Shlomo Rodav

Employed by the Company as active chairman of the Board of Directors under a personal employment agreement dated April 29, 2008, which has been valid since September 4, 2007 (date he started working as active chairman of the Company's board of directors). Mr. Rodav ceased serving as the chairman of the Board of Directors on December 31, 2010 and will continue to serve as a director until the next annual general meeting. Mr. Rodav is in the prior notice period, which is for six months as of the date of his announcement of termination of service (December 2, 2010) and accordingly, he is eligible to receive his salary until June 6, 2011. Under his employment agreement, the former Chairman's monthly salary is NIS 175,000 and is linked to the CPI (during the reporting year, his gross monthly salary was NIS 194,000). In addition, the Chairman is eligible for ancillary benefits and social benefits such as directors insurance, study fund, company car (level 7 equivalence for tax purposes), full reimbursement from the Company of communications expenses, as well as annual leave, sick and

[12] See footnote 12 above

convalescence days and reimbursement of expenses incurred while fulfilling his position. On June 1, 2008, 9,000,000 options were allotted to the Chairman at an exercise price of NIS 6.4405 (adjusted for distribution of dividend). The B&S value of all the options allotted to the former Chairman, as at allotment date, is NIS 16.807 million. The options were divided into 12 (twelve) equal tranches; the first tranche vested after three months from the grant date, and further tranches vest every three months thereafter, so that all the options vest gradually over a period of three years from the grant date. As of this report date, 8,250,000 of the options have vested.[13] By the end of the prior notice period, another 750,000 options are expected to vest.

Changes in remuneration instituted in the reporting year: On April 8, 2010 the general meeting of the Company's shareholders approve the maximum bonus for 2009 for the chairman of the board of directors under his employment agreement dated June 1, 2008, equivalent to 18 monthly salary payments in the total amount of NIS 3,444,480. As aforesaid, this amount which is for 2009 is not included in the foregoing remunerations table.[14]

On March 7, 2011 the Company's Board of Directors resolved (after receiving the approval of the Company's compensations and audit committees) to approve the maximum bonus for the Chairman, as per his employment agreement, of 18 salaries based on December 2010 salary, in the amount of NIS 3,507,000. This bonus is subject to approval at the Company's general shareholders meeting.

D. <u>Alan Gelman</u>

Employed by the Company as the deputy CEO and CFO under a personal employment agreement dated November 29, 2007, which became effective on February 15, 2008. The agreement is for an unlimited period, and it may be terminated by either party at any time and for any reason with 6 months prior notice. The salary of the deputy CEO and CFO is NIS 130,000 and is linked to the CPI published in January 2008 (in the reporting year his gross salary amounted to NIS 144,000. In addition, the deputy CEO and CFO is eligible to receive ancillary benefits and social benefits such as company car, communications expenses, study fund, reimbursement of expenses, as well as leave, sick and convalescence days.

On March 7, 2008, 3,500,000 options[15] were allotted to the deputy CEO and CFO at an exercise price of NIS 5.50 (adjusted for distribution of dividend). The B&S value of all the options allotted to the deputy CEO and CFO, as at allotment date, is NIS 10.518 million.

In December 2009 the Company's board of directors approved bonus goals for the deputy CEO and CFO, which were based on the Company's annual work schedule for 2010, and included several criteria: (a) EBITDA goal for the Company (solo), which constitutes 50% of the bonus calculation; (b) personal-managerial goals that together constitute 30% of the bonus calculation; (c) assessment of the deputy CEO and CFO, which constitutes 20% of the bonus calculation The deputy CEO and CFO's bonus was limited to 80% of his annual salary for meeting 100% of the goals stipulated above, however the Company's Board of Directors is entitled to consider increasing the bonus to more than 80% of the annual salary, subject to the approval of the Company's audit committee.

Changes in remuneration instituted in the reporting year: On March 2, 2010 the Company's Board of Directors (upon receipt of the approval of the Company's compensations committee and audit

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[13] The options are exercisable from the end of the vesting period of each tranche of options until four years have elapsed from the grant date of the options. The options were granted in accordance with the option plan for senior managers and employees (2007) as reported in the Company's immediate report dated December 25, 2007 and in accordance with a material private placement report, to the chairman of the board of directors as approved by the General Meeting of the Company's shareholders on June 1, 2008 and as reported in the Company's immediate report dated April 18, 2008.

[14] Under the Chairman's employment agreement, as approved by the general meeting of the Company's shareholders on June 1, 2008, and as reported in the Company's immediate report of April 18, 2008, the Chairman is entitled to an annual bonus amount, if it is decided to grant him a bonus, of six to eighteen monthly salaries.

[15] One-third of the options vest one calendar year after the grant date, another third of the options vest after two calendar years from the grant date and the final third of the options vest after three calendar years from the grant date. Shortly prior to the publication of the financial statements, 1/3 of the deputy CEO and CFO's options had vested. The options are exercisable from the end of the vesting period of each tranche of options until five years have elapsed from the vesting date of the third tranche of options. The option remuneration is granted pursuant to the option plan for managers and senior officers (2007) as reported in the Company's immediate report dated December 25, 2007

committee) approved a bonus for the deputy CEO and CFO for 2009 in an amount of NIS 1,165,343. As aforesaid, this amount which is for 2009 is not included in the foregoing remunerations table.

On March 3, 2011 the Company's board of directors (upon receipt of the approval of the Company's compensations committee and audit committee) approved the bonus for the deputy CEO and CFO for 2010 in an amount equivalent to 80% of the deputy CEO and CFO's annual salary, in the amount of NIS 1,386,000.

E. Yitzhak Benbenisti

Employed as CEO of the subsidiary Bezeq International since November 6, 2007, under a personal employment agreement dated July 1, 2007. The agreement is for an unlimited period, and it may be terminated by either party at any time and for any reason with 3 months prior notice. His monthly salary during 2010 amounted to NIS 100,000 with the addition of cost-of-living increase. In addition, he is eligible to receive ancillary and social benefits such as company car, mobile phone, pension insurance, study fund, as well as generally accepted annual leave, sick and convalescence days.

On February 4, 2008, 2,500,000 options[16] were allotted to the CEO of Bezeq International at an exercise price of NIS 5.50 (adjusted for distribution of dividend). The B&S value of all the options allotted to the CEO of Bezeq International, as at allotment date, is NIS 6.786 million.

In December 2009, after receiving approval of the audit committee and board of directors of Bezeq International, the Company's Board of Directors set an EBITDA goal (based on Bezeq International's solo financial statements) for the CEO of Bezeq International's annual bonus for 2010. The CEO of Bezeq International bonus was limited to 80% of his annual salary for meeting 100% of the bonus goal, however the Company's Board of Directors is entitled to consider increasing the bonus to more than 80% of the annual salary, subject to the approval of the Company's audit committee and the board of directors and audit committee of Bezeq International.

Changes in remuneration instituted in the reporting year: On March 2, 2010 the Company's Board of Directors approved a bonus for the CEO of Bezeq International for 2009 in the amount of NIS 960,000. As aforesaid, this amount which is for 2009 is not included in the foregoing remunerations table.

Under the retention plan approved by the Company's institutions on December 30, 2009, the CEO of Bezeq International was allotted a retention bonus equivalent to nine months salary (which was paid as a loan during January 2010). Furthermore, his options agreement was amended so that in the event that he is dismissed (and not if he resigns), within one year (instead of six months) from the date of transfer of control, the vesting period for the unvested balance of options at date of dismissal will accelerate.

On December 30, 2010 the Company's board of directors approved a bonus plan for the Group's senior managers, including the CEO of Bezeq International, as of 2011. 1 The annual bonus plan for the CEO of Bezeq International was amended so that he will be entitled to an annual bonus equivalent to 100% of his annual salary for compliance with goals set for him each year and equivalent to up to 125% of his annual salary for performance exceeding these goals. 2 The CEO of Bezeq International was allotted 2,000,000 phantom options at exercise price of NIS 10.206. 3 The salary of the CEO of Bezeq International was amended and increased as of January 1, 2011 to NIS 125,000, linked to the CPI for December 2010. For further information see the immediate report amendment concerning an extraordinary transaction with an officer dated January 3, 2010, noted here by way of reference.

On March 3, 2011 the Company's board of directors (upon receipt of the approval of the board of directors of Bezeq International and of the Company's compensations committee and audit committee) approved the bonus for the CEO of Bezeq International for 2010 in an amount equivalent to 120% of the annual salary of the CEO of Bezeq International, in the amount of NIS 1,440,000.

Other interested parties who receive remuneration from the Company

A. **Rami Nomkin**, an employee director, who serves as manager of the sales department, has been employed by the Company as a permanent employee since 1966. All the remunerations paid to Mr. Nomkin are due to his being an employee of the Company and not for his service as a Company director. Mr. Nomkin’s total salary for 2010 amounted to NIS 592,000 and is linked to the professional salary tables. This salary includes a bonus for 2010 in the amount of NIS 19,556 which has not yet been paid and which was set in accordance with the criteria for all the Company's employees, based on the Company's EBITDA results.

[16] See footnote 12 above

On January 25, 2011 the Company's general meeting approved allotting 47,774 options to Mr. Nomkin, at an exercise price of NIS 7.457 (subject to adjustments for the distribution of dividend), under a material private placement report for an employee director dated December 20, 2010. The Black and Scholes value of all the options allotted to the CEO of Pelephone is NIS 182 million[17] The options were allotted to Mr. Nomkin as an employee of the Company and not for his service as a Company director.

On November 22, 2010 the Company's general meeting approved awarding financial compensation to the employee directors, Rami Nomkin and Yehuda Porat, for the delay in allotment of options to them under the employee options plan of 2007, due to the need to have the allotment approved by the general meeting of the Company's shareholders because they serve as directors of the Company. Mr. Nomkin's compensation, based on the calculation made by the Company, amounts to a total of NIS 12,310 net.

B. **Yehuda Porat**, an employee director, serves as manager of the Company's security and safety department and is employed by the Company under a personal employment agreement dated October 29, 2007 (which was updated in May 2009). The agreement is for an unlimited period, and it may be terminated by either party at any time and for any reason with 3 months prior notice. The entire remuneration (including options as set forth below) are paid to Mr. Porat for his being a Company employee and not for his service as a Company director. . Mr. Porat's salary is linked to the CPI. The total remuneration (including options as set out below) paid to Mr. Porat for 2010 amounted to NIS 740,000. This salary includes a bonus for 2010 (which has not yet been paid) in the amount of NIS 100,000, which is subject to the approval of the general meeting of the Company's shareholders, which has not yet convened. The bonus was set in accordance with compliance with goals and the opinion of a manager.

On May 3, 2009 the Company's general meeting approved allotting 100,000 options to Mr. Porat, at an exercise price of NIS 5.9703 (subject to adjustments for the distribution of dividend), under a material private placement report for an employee director dated January 21, 2009. The B&S value of all the options allotted to Mr. Porat, as at allotment date, is NIS 297,000.[18]

On January 25, 2011 the Company's general meeting approved allotting 39,681 options to Mr. Porat, at an exercise price of NIS 7.457 (subject to adjustments for the distribution of dividend), under a material private placement report for an employee director dated December 20, 2010. The Black and Scholes value of all the options allotted to Mr. Porat is NIS 151 million[19] The options were allotted to Mr. Porat as an employee of the Company and not for his service as a Company director.

On November 22, 2010 the Company's general meeting approved awarding financial compensation to the employee directors, Rami Nomkin and Yehuda Porat, for the delay in allotment of options to them under the employee options plan of 2007, due to the need to have the allotment approved by the general meeting of the Company's shareholders because they serve as directors of the Company. Mr. Porat's compensation, based on the calculation made by the Company, amounts to a total of NIS 6,087 net.

C. **Remuneration for two external directors**[20] is in accordance with the maximum tariffs prescribed in the Companies Regulations (Rules Concerning Remuneration and Expenses for an External Director), 2000 (for external expert directors) linked to the CPI as set in said regulations and which was updated under an amendment which took effect on March 6, 2008 and which was approved by the general meeting on June 1, 2008. The remuneration paid in 2010 to Mr. Mordechai Keret amounts to NIS 416,016 and to Mr. Yitzhak Edelman amounts to NIS 413,322 (including the reimbursement of travel expenses as approved by the general meeting of the Company's shareholders on September 28, 2008 and which was reported in the Company's immediate report of that date).

On January 27, 2010 the general meeting approved the appointment of Mr. Yitzhak Edelman as an external director of the Company for an additional period of three years as from February 1, 2011.

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[17] One-third of the options vest one calendar year after the grant date, another third of the options vest after two calendar years from the grant date and the final third of the options vest after three calendar years from the grant date. The options are exercisable from the end of the vesting period of each tranche of options until five years have elapsed from the vesting date of the third tranche of options.

[18] See footnote 18.

[19] See footnote 18.

[20] On January 31, 2010 Eyal Yaniv terminated his term as an external director in the Company - for the period during which he served as a director in 2010, Mr. Yaniv was paid the amount of NIS 39,673.

D. **Remuneration for two independent directors** [21] is based on the maximum tariff (for an expert external director) as prescribed in the Companies Regulations (Rules Concerning Remuneration and Expenses for an External Director), 2000, linked to the CPI as set in said regulations and which was updated under the foregoing amendment. The remuneration for 2010 paid to Mr. Eldad Ben Moshe is NIS 60,415 and to Mr. Yehoshua Rozenzweig is NIS 36,921 (including reimbursement of travel expenses as approved by the general meeting of the Company's shareholders on September 28, 2008 and which was reported in the Company's immediate report of that date).

E. **Management fees paid to Ap.Sb.Ar**. Pursuant to the terms of the agreement which was extended on September 28, 2008 by the Company's general meeting for a further period of three years as of January 1, 2009 until December 31, 2011, Ap.Sb.Ar Cayman L.P., a company related to Ap.Sb.Ar. Holdings Ltd., the former controlling shareholder in the Company ("Ap.Sb.Ar."), provided the Company with management and consultancy services in return for USD 1.2 million per year (as set forth in the transaction report and notice of convening of a general meeting dated August 13, 2008, noted here by way of reference). On the date of transfer of control of the Company (April 14, 2010), Ap.Sb.Ar. Cayman LP ceased being a service supplier to the Company, by virtue of the foregoing agreement. For the period commencing January 1, 2010 through to April 14, 2010 Ap.Sb.Ar Cayman L.P. was paid an amount of NIS 1,284,900 in lieu of foregoing management services. For further information in this regard also see Note 30 to the financial statements.

F. **Management fees for Eurocom Communications Ltd**. On June 10, 2010 the Company's general meeting approved signing an agreement with Eurocom Communications Ltd. ("Eurocom Communications"), the controlling shareholder (indirectly) of the Company, for consultancy and management services for a period of three years as of May 30, 2010 through to June 1, 2013 in return for an annual fee of USD 1.2 million (for a description of the main points of the agreement, see section 9.C.3 below). For the period June 1, 2010 through to December 31, 2010, the amount of NIS 2,540,900 (before VAT) was paid to Eurocom Communications for the consultancy services.

8. Standard 21A: Controlling shareholder

A. Controlling Shareholder at Reporting Date

To the best of the Company's knowledge, the controlling shareholder in the Company (through holdings) is B Communications Ltd. ("B Communications"), a company controlled by Internet Gold – Golden Lines Ltd. ("Internet Gold"), which is controlled by Eurocom Communications. Eurocom Communications is controlled by Mr. Shaul Elovitch,[22] the Chairman of the Company's board of directors. All as set forth below:

814,211,545 Company shares, constituting 30.29% of the issued and paid-up share capital as at the reporting date, are held by B. Communications (S.P. 2) Ltd. ("B Communications 2"), a private company registered in Israel, which is wholly owned and controlled by B Communications (S.P. 1) Ltd. ("B Communications 2"), a private company registered in Israel. To the best of the Company's knowledge, B. Communications 1 is wholly owned and controlled by B Communications Ltd., an Israeli public company whose shares are traded by way of dual listing on the TASE and the NASDAQ.

To the best of the Company's knowledge, the controlling shareholder in B Communications is Internet Gold, an Israeli public company whose shares are traded by way of dual listing on the TASE and the NASDAQ, which holds 73.89% of the issued and paid-up share capital of B Communications. To the best of the Company's knowledge, Eurocom Communications Ltd., a private company controlled by Mr. Shaul Elovitch, is the owner and holder of 1.37% of the issued and paid-up share capital of B Communications.

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[21] The remuneration for independent directors was approved by the Company's board of directors on October 14, 2010 and became effective with regard to Mr. Eldad Ben Moshe on October 14, 2010 and with regard to Mr. Yehoshua Rosenzweig upon his appointment as an independent director, i.e. as of November 22, 2010.

[22] To the best of the Company's knowlege, the controlling shareholders in Eurocom Communications are as follows: (a) Eurocom Holdings (1979) Ltd. ("Eurocom Holdings"), which holds 50.33% of the issued and paid-up shareholders equity. Eurocom Holdings (1979) Ltd. is a private company owned by Mr. Shaul Elovitch who holds 80% of its ordinary shares and 75% of its management shares and his brother, Mr. Yosef Elovitch holds 20% of its ordinary shares and 25% of its management shares; (b) Four private companies owned by Mr. Shaul Elovitch and his brother, Mr. Yosef Elovitch (at holdings of 80% and 20%, respectively) which hold 49% of the issued and paid-up share capital of Eurocom Communications.

To the best of the Company's knowledge, the controlling shareholder of Internet Gold is Eurocom Communications, which holds 73.87% of the issued and paid-up share capital of Internet Gold. To the best of the Company's knowledge, Mr. Eli Holtzman, a director and the CEO of Internet Gold and B Communications, holds 0.90% of the issued and paid-up share capital of Internet Gold.

It is also noted that Ms. Iris Elovitch, the wife of Mr. Shaul Elovitch, holds 72,360 ordinary shares of Bezeq (as noted in the table in section 10 above), and 24,793 shares of Internet Gold (constituting a negligible share of the issued and paid-up equity) and 3,177 shares of B Communications (constituting a negligible share of the issued and paid-up equity).

B. The former controlling shareholders in the Company

Until April 14, 2010, Ap.Sb.Ar. was the controlling shareholder of the Company.

9. Regulation 22: Transactions with the controlling shareholder

Below are particulars, to the best of the Company's knowledge, concerning all transactions with the controlling shareholders of the Company, or in which the controlling shareholders have a personal interest ("transaction with the controlling shareholders"), which the Company, its subsidiaries or its related companies (together - "the Group") engaged in during the reporting year or subsequent to the end of the reporting year and until the date on which this report is submitted, or which is still valid at the reporting date:

A. General - negligible procedures

On March 7, 2011, the Company's Board of Directors resolved to adopt guidelines and regulations to classify a transaction of the Company, its subsidiary or associate with an interested party as a negligible transaction, which is not an extraordinary transaction, as set out in Regulation 41(A)(6) of the Securities Regulations (Annual Financial Statements), 2010 ("Financial Statements Regulations"). These guidelines and regulations are also used to examine the scope of disclosure in periodic reports and prospectuses (including shelf offering reports) regarding a transaction of the Company, a company under its control and a subsidiary or associate with a controlling shareholder or in which the controlling shareholder has a personal interest as set out in Regulation 22 of the Securities Law (Periodic and Immediate Reports), 1970 ("Periodic Report Regulations") and Article 54 of the Securities Regulations (Prospectus Details and Draft Prospectus – Structure and Form), 1969, and to examine the need to submit an immediate report for such transaction of the Company, as set out in Regulation 37(A)(6) of the periodic reports regulations (types of transactions determined in the financial statements regulations, the periodic reports regulations and the prospectus details regulations referred to above ("interested party transactions").

From time to time, the Company and its subsidiaries or associates carry out negligible transactions, which are not extraordinary transactions, with an interested party in the Company or with related parties, of the types and nature detailed below: Transactions for the sale or purchase of products and services, such as communication products and services, including fixed-line and cellular handsets, software development products and services, maintenance services, voice-mail service agreements, rental transactions of real estate properties and advertising services.

In the absence of special, qualitative considerations in the circumstances, a transaction that is in the Company's regular course of business, is carried out in market conditions and it has no material effect on the Company, shall be deemed negligible if all the following parameters exist:

1 The amount of the transaction does not exceed NIS 10 million.[23]

2 The Company is not required to issue an immediate report for the transaction under Article 36 of the periodic reports regulations or any other law.

3 The transaction does not address the employment terms (as set out in the Companies Law, 1999 ("the Companies Law")) of the interested parties or their relatives.

According to the provisions of the Companies Law, as may be from time to time, once a year, before publication of the annual financial statements, the audit committee will review the parameters set out above, and whether they require updating.

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[23] This is an amount less than 0.1% of the Company's assets and of its revenues.

In general, each transaction will be tested separately for negligibility. Notwithstanding the aforesaid, separate transactions that are part of the same continuing transaction or very similar transactions that are carried out routinely and repeatedly, will be tested as one transaction on an annual basis for negligibility, provided the scope of the transaction does not exceed NIS 10 million, as set out above.

The Board of Directors may, from time to time and at its discretion, amend the parameters for a negligible transaction. This amendment will be duly reported.

B. Negligible transactions

During the reporting period, the Group carried out negligible transactions, which are not extraordinary transactions, with interested parties in the Company or which the controlling shareholder has a personal interest, of the types and nature stipulated in the negligible transactions above. See also Note 30 to the financial statements. The Group's transactions with a controlling shareholder or in which the controlling shareholder has a personal interest, and which are not extraordinary, are classified by the Company as negligible or not negligible, based on the guidelines in the negligible procedures.

C. Transactions that are not negligible

Transactions included in section 270(4) of the Companies Law

1. Debt settlement with DBS

A. On May 20, 2010, the general meeting of the Company (following approval of the audit committee and the board of directors) approved a debt settlement between the Company and DBS, with regard to the balance of DBS's debt to the Company, in the amount of NIS 31.5 million for communications services as at July 31, 2009, which DBS will pay to Bezeq in 36 equal monthly installments of NIS 875,000 each, with the addition of VAT and the addition of interest at prime + 1.5%, with the addition of VAT on the interest, as required by law.

B. On October 14, 2010, the general meeting of the Company’s shareholders approved the Company’s agreement with DBS with an amendment to the debt settlement of May 2010 and September 2006. Under the amendments, all the payments that are due from July 1, 2010 to December 31, 2011 will be deferred for 18 months, against payment of annual interest of prime + 3% plus VAT for the interest. The deferred payments amount to NIS 45.4 million.

C. On October 14, 2010, the general meeting of the Company’s shareholders (following approval by the audit committee and the board of directors) approved the agreement between Bezeq International and DBS with an amendment to the debt settlement of January 2010 (regarding DBS’s debt to Bezeq International amounting to NIS 8,370,000 in 24 equal monthly payments for payment commencing from July 1, 2010 plus interest at prime + 1% and VAT). Under the amendment, each of these payments will be deferred for 18 months, against payment of annual interest of prime + 3% plus VAT for the interest.

For further information, including with respect to the matter of the controlling shareholders who have a personal interest, see: Transaction report and notice of convening of an extraordinary general meeting published by the Company on March 18, 2010, and the supplementary report dated April 14, 2010; transaction report and notice of convening of an extraordinary general meeting published by the Company on September 6, 2010 (regarding the agreement A in said report), noted here by way of reference.

2. Approval of the settlement with Yacov Gelbard, former CEO of the Company,

On May 20, 2010, the general meeting of the Company’s shareholders approved the settlement agreement between the Company and Yacov Gelbard, former CEO of the Company (after approval of the audit committee and Board of Directors) in which all of the mutual claims of the parties are dismissed, including claims against other Group companies and their representatives.

Mr. Gelbard was employed as the Company's CEO from October 11, 2005 and on April 30, 2007 Mr. Gelbard employment as the Company's CEO terminated, following a joint notice issued by the parties on said date.

After termination of his employment at the Company, disputes arose regarding the rights and moneys to which Yacov Gelbard is entitled for issues related to his employment and severance. The disputes included claims by Yacov Gelbard regarding his right to be included in the officers’ options plan and the compensation to which he is entitled under this plan. After negotiations between the parties and their representatives, the Company and Yacov Gelbard reached a settlement agreement. The main points of the settlement agreement are as follows: The Company will pay Yacov Gelman a lump sum of NIS 9 million (gross). After this payment, there will be no further accounting and/or demands in respect of amounts paid to Yacov Gelbard and/or returned by him during and/or after his employment (including amounts offset from Yacov Gelbard. The Company, on its part, hereby declares on its behalf and on behalf of any company of the Bezeq Group, that they will have no demands, contentions or claims against Mr. Gelbard, including claims in respect of repayments of additional moneys that the Company asserted that Mr. Gelbard unlawfully received, and it they did have such claims they waive them fully and absolutely. This payment is without any admission of either party of the claims, demands or positions of the other party. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of an extraordinary general meeting published by the Company on March 18, 2010 and supplementary report dated April 14, 2010, noted here by way of reference.

3. <u>Management services</u>

On June 10, 2010, the general meeting of the Company's shareholders following approval by the audit committee and the board of directors) approved an agreement between the Company and Eurocom Communications Ltd., (in this section - "the Managing Company"). Under the agreement, Eurocom will provide the Company with ongoing management and consultation services for an annual fee of USD 1.2 million over three years, commencing from June 1, 2010 through to May 31, 2013, unless one of the parties announces its intention to terminate the agreement with three-months notice. The main services provided by the management company are: 1 Consultation services for the Company's operations, including strategy, business development, regulation, marketing and any other consultation that the Company requires as a communications company and as a group of companies, and ongoing management services. 2 The services will be supplied from June 1, 2010 and for the term of the agreement by managers and/or employees and/or consultants of the management company and/or its shareholders and anyone that the management company deems suitable to supply the services. 3. The management company will provide professional and skilled human resources and other resources that are required to supply the services, including managers and consultants with a background in communications and with international experience, in order to provide Bezeq Group professional and high-quality service. In addition, according the consultation agreement, until otherwise decided, the Company's directors, except for outside directors, independent directors and the chairman of the Board of Directors, will not receive directors compensation from the Company or the subsidiaries. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of a general meeting published by the Company on May 4, 2010 (concerning agreement A in the said report) and supplementary report dated June 1, 2010, noted here by way of reference.

4. <u>Agreement for acquisition and supply of Nokia products</u>

On June 10, 2010, the general meeting of the Company's shareholders (following approval by the audit committee and the board of directors) approved an agreement between the subsidiary, Pelephone and Eurocom Cellular Communications Ltd. for acquisition and supply of Nokia products to Pelephone (terminal equipment, spare parts and accessories) and maintenance services for these products. The contract period is from April 14, 2010 through to December 31, 2012. The scope of the annual purchases under the agreement will not deviate from a cumulative amount of NIS 450 million per year (the calculation for 2010 will be made from the beginning of the year). Any purchases exceeding this amount will be subject to prior approval by law. An annual increase of up to NIS 45 million (excluding VAT) will only require the approval of the audit committee and Board of Directors of the Company (Bezeq), as well as the approval of the certified organs of Pelephone and Eurocom. Cellular Communications Ltd. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of a extraordinary general meeting published by the Company on May 4, 2010 (concerning agreement C in the said report) and supplementary report dated June 1, 2010, noted here by way of reference.

5. <u>Authorization to sell routers</u>

On October 14, 2010, the general meeting of the Company's shareholders (following approval by the audit committee and the board of directors) approved an agreement between the

Company and DBS. Under the agreement, DBS will be allowed to sell its customers a wireless router of the Company, according to the terms of the agreement with the Company which are in effect at the time, and to deliver and install the router, with no charge. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of an extraordinary general meeting published by the Company on September 6, 2010 (concerning agreement B in said report), noted here by way of reference.

6. Reciprocal marketing agreements (Bezeq and Bezeq International)

A. On October 14, 2010, the general meeting of the Company's shareholders (following approval by the audit committee and the board of directors) approved an arrangement between the Company and DBS for reciprocal marketing of products and services. According to the arrangement, the Company may market DBS services (satellite television) and DBS may market the Company's services (ADSL internet, telephony and value added services).

B. On October 14, 2010, the general meeting of the Company's shareholders (following approval by the audit committee and board of directors) approved an arrangement between Bezeq International and DBS for reciprocal marketing of products and services. According to the arrangement, Bezeq International may market DBS services (satellite television) and DBS may market Bezeq International's services (internet access, international calls, VoB and value added services).

For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of an extraordinary general meeting published by the Company on September 6, 2010 (concerning agreement B in said report), noted here by way of reference.

7. Agreements to purchase satellite terminal equipment[24]

A. On July 29, 2010 the general meeting of the shareholders of the Company (following approval of the audit committee and the board of directors) approved the Company's vote at the general meeting of DBS in favor of the agreements between DBS and Advanced Digital Broadcast S.A. ("**ADB**") and Eurocom Digital Communications Ltd. for the purchase of 47,500 yesMaxHD converters at a cost of USD 9,796,400 and for obtaining USD suppliers credit for a further period of 60 days from Eurocom Digital Communications Ltd. with regard to the purchase of decoders. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of an extraordinary general meeting published by the Company on June 23, 2010, noted here by way of reference.

B. On March 7, 2010, the Company's Board of Directors approved an agreement with DBS (after approval of the audit committee), as follows: (1) an additional order, further to the order in subsection 1, of yesMaxHD decoders from Eurocom Digital Communications and from ADB, in accordance with the existing framework agreement and to upgrade (partial or fully optional, at the discretion of DBS) the hard drive of the converters at an overall cost of USD 10.3 million (for sea shipment). Should DBS require earlier delivery that requires air shipment, DBS will pay Eurocom the extra cost for the air shipment); (2) receipt of USD suppliers credit from Eurocom Digital Communications for another 60 days ("the additional credit period") for the purchase of the converters. The payment terms set out in the framework agreement is EOM + 35 and for the additional credit period, DBS will pay interest at a rate of 1% (6% in nominal annual terms). The scope of the credit is estimated at an average of NIS 11 million and payment of the annual interest is estimated as NIS 578,000. This approval requires the approval of the general meeting of the shareholders of the Company; (3) an order of power supplies for yesMaxHD converters from Eurocom Digital Communications and from ADB, until May 31, 2012, at a total cost of USD 130,000.

[24] For the sake of caution, the agreements specified in this section were brought or will be brought, as the case may be, for approval by the general meeting of the shareholders of the Company in accordance with section 275 of the Companies Law, pursuant to the conditions prescribed in the Ministry of Communications approval for the transaction for the acquisition of control in the Company by B Communications (see section 1.1.3.A.1 of Chapter A of the periodic report).

8. **Officers insurance**

On March 8, 2010, the general meeting of the Company's shareholders approved (after approval of the audit committee and the Board of Directors) the conversion of the directors' and officers' liability insurance policy to a run-off policy[25], commencing from the date of transfer of control from Ap.Sb.Ar. Holdings Ltd. to B Communications, for seven years from this date. The limit of liability is up to USD 50 million for claims and in total for the insurance period. In addition, the liability limit is up to USD 20 million per claim and in total for the insurance period for legal expenses in Israel only. The liability limit for subsidiaries is half of this amount (as part of the above liability limit). The annual premium for the policy is $380,500. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of an extraordinary general meeting published by the Company on January 31, 2010, noted here by way of reference.

9. **Undertaking to indemnify in advance for new directors in the Company**

On June 10, 2010, the general meeting of the Company's shareholders (following approval by the audit committee and the board of directors) approved the undertaking to indemnify in advance directors who are controlling shareholders in the Company and/or their relatives: Messrs Shaul Elovitch, Or Elovitch, Orna Elovitch-Peled (in addition to the approval to indemnify as aforesaid for additional directors appointed at the time of transfer of control in the Company). The liability will be provided in a deed of indemnity that is similar to the deed of indemnity granted to the other officers in the Company, as set out below: (a) undertaking to indemnify the Company's officers for any liability or expense imposed on the officers due to their actions in their capacity as an officer in the Company (including their actions in subsidiaries), within the limitations provided in the Companies Law. (b) the total amount of the indemnity was limited to a ceiling of 25% of the equity of the Company as may be at the time of actually paying the indemnity.

For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of a extraordinary general meeting published by the Company on May 4, 2010 (concerning agreement B in the said report) and supplementary report dated June 1, 2010, noted here by way of reference.

It is noted that the Company undertakes to indemnify in advance, as aforesaid, for all the officers in the Company.

10. **Continuation of the D&O liability insurance policy**

On November 22, 2010, the general meeting of the Company's shareholders (following approval by the audit committee and the Board of Directors) approved the continuation of the Company's D&O liability insurance policy, which was approved by the Company's audit committee and Board of Directors (on January 24, 2010 and January 28, 2010, respectively), as part of the framework transaction that was valid until October 10, 2010. The continuation of the foregoing policy is from that date until the end of the current policy, until April 13, 2011. Terms of the existing insurance policy: A. Policy covering the liability of directors and officers in the Company, as they may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, all the directors and officers in companies in which the Company holds 50% or more, directors and officers representing the Company in companies in which the Company holds less than 50%, and senior employees who are not officers for managerial actions taken by them. B. Limits of liability: The liability limit is USD 50 million per claim and in total for all claims in the insurance period and USD 10 million per claim and in total for the each year of insurance for legal expenses in Israel only. The liability limit for subsidiaries is half of this amount (as part of that liability limit). C. The annual premium for the policy is USD 140,000. For further information, including pertaining to the matter of controlling shareholders who have a personal interest, see transaction report and notice of convening of an general meeting published by the Company on October 14, 2010, noted here by way of reference.

[25] Covering the liability of directors and officers, as they may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, all the officers in companies in which the Company holds 50% or more, officers representing the Company in companies in which the Company holds less than 50%, and senior employees who are not officers for managerial actions taken by them.

11. **Framework transaction for D&O liability insurance**

On March 7, 2011 the Company's Board of Directors, subsequent to approval by the audit committee, approved a framework transaction, subject to approval by the general meeting for a period of three years from April 14, 2011 through to April 13, 2014, for the Company's engagement, during the normal course of business, in future insurance policies to cover the liability of directors and officers, as may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, and all by way of a framework transaction as defined in the Companies Regulations (Reliefs in Transactions with an Interested Party), 2000 ("**Relief Regulations**"). The Company will acquire a policy with liability limit of USD 100 million per claim and in total for each insurance year, and up to USD 20 million per claim or in total for the insurance period for legal expenses in Israel only Furthermore, the accumulative liability limit for subsidiaries is half of this amount (as part of the above liability limit). The annual premium that the Company will pay will not exceed USD 185,000 with the addition of up to 20% of this amount. The Company will be permitted to acquire insurance with liability limit exceeding USD 100 million provided that the annual premium that the Company will pay will not exceed USD 185,000 with the addition of up to 20% of this amount. Any purchase of a new insurance policy in the future as mentioned above will be approved by the Company's Audit Committee and the Board of Directors who will determine whether it complies with the terms of the framework transaction as set forth above.

12. **Acquisition of an officers liability insurance police for one year**

On March 7, 2011, the audit committee and Board of Directors resolved to approve an agreement to purchase a D&O insurance policy from April 14, 2011 through to April 13, 2012. The annual premium that the Company will pay is USD 185,000. The liability limit is USD 100 million per claim and in total for each insurance year, and up to USD 20 million per claim or in total for the insurance period for legal expenses in Israel only Furthermore, the accumulative liability limit for subsidiaries is half of this amount (as part of the above liability limit).The transaction requires approval of the general meeting. With regard to directors who are controlling shareholders or their relatives, the policy was approved in accordance with Regulation 1B(5) of the Relief Regulations. Accordingly, in the event that an objection is lodged as stipulated in Regulation 1C(a) of the Relief Regulations with respect to the application of the policy for directors who are controlling shareholders or their relatives, the policy will require the approval of the general meeting by majority vote as set forth in section 275 of the Companies Law.

13. **Use of space segments by DBS from Space Communications Ltd. ("Spacecom")**

DBS has a series of agreements with Spacecom, a company controlled by Eurocom Holdings and Eurocom Communications, for the use of space segments of Amos 2 and Amos 3 satellites. The lease fees DBS paid Space in 2010 amounted to NIS 87 million. These agreements were signed before B Communications acquired control in the Company, therefore at the date the agreements were signed, the approval of the Company's organs was not required pursuant to Chapter 5 in Part VI of the Companies Law For further information pertaining to the terms of the agreement see section 5.18.1 of Chapter A of the periodic report.

Transactions not included in section 270(4) of the Companies Law and are not negligible

1. **DBS raising debt**

On November 2, 2010 the Company's audit committee and board of directors resolved that the Company will vote at the general meeting of the shareholders of DBS in favor of raising debt by DBS in a total amount of up to NIS 450 million. For further information see immediate report concerning the approval of a transaction in which the controlling shareholder of the Company has a personal interest, dated November 2, 2010. On March 7, 2011, the Company's board of directors (following approval by the audit committee) approved the Company voting in the general meeting of the shareholders of DBS in favor of raising debt by DBS in a total amount of NIS 120 million

2. **Acquisition of converters and settlement agreement to dismiss mutual claims**

On March 7, 2010, the Company's Board of Directors (after approval of the audit committee), approved a settlement agreement with Pace Micro Technology Plc ("**Pace**") to end and settle the claim that DBS filed against Pace (principal of NIS 31 million) and the counter-claim filed by Pace against DBS and against Eurocom Digital Communications (principal of NIS 43 million).

For a description of the foregoing litigations also see section 5.20.1.A of Chapter A of the periodic report. Under the settlement agreement, all the foregoing legal proceedings will be terminated without any of the parties admitting to the claims of the other parties, DBS will purchase converters from Pace (in a total amount of USD 4.158 million) and Pace will provide DBS, fee of charge, an additional quantity of converters (equivalent in total, in accordance with the terms of the purchase agreement for the converters, amounting to USD 1.8 million). For the sake of caution, the settlement agreement was brought for approval of the audit committee and the board of directors of the Company as a transaction that is not extraordinary and in which the controlling shareholder has a personal interest. As of the reporting date, the foregoing settlement agreement has not yet been signed.

10. Regulation 24: Holdings of interested parties and senior officers in shares and other securities of the Company, a subsidiary or related company, as close as possible to the reporting date

A. Company shares and securities convertible into shares of the Company

Name of holder	Type of security[26]	Number of convertible NIS securities - ratio 1:1	Number of NIS 1 par value shares each	Rate of holding in votes and in equity [27]	Number of NIS 1 par value shares Fully diluted	Percentage of holding Fully diluted
B. Communications Ltd.	Ordinary shares	-	814,211,545	30.29%	814,211,545	29.08%
Shlomo Rodav (Director)	Executive options	9,000,000	-	0.00%	9,000,000	0.32%
Amikam Shorer (Director)	Ordinary shares	-	41,869	0.00%	41,869	0.00%
Rami Nomkin (Director)	2010 Options	47,774	-	0.00%	47,774	0.00%
Yehuda Porat (Director)	Executive options	100,000	-	0.00%	100,000	0.00%
	2010 Options	39,681	-	0.00%	39,681	0.00%
Avi Gabbay (CEO)	Ordinary shares	-	20,600	0.00%	20,600	0.00%
	Executive options	2,844,483	-	0.00%	2,844,483	0.10%
Shaul Elovitch (Chairm of Board of Directors)[28]	Ordinary shares	-	72,360	0.00%	72,360	0.00%
Alan Gelman (Deputy CEO and CFO)	Executive options	1,166,667	-	0.00%	1,166,667	0.04%
Linor Yochelman (Company Secretary)	Executive options	33,334	-	0.00%	33,334	0.00%
	2010 Options	41,000	-	0.00%	41,000	0.00%
Danny Oz (Accountant)	Ordinary shares	-	4,702	0.00%	4,702	0.00%
	Executive options	100,000	-	0.00%	100,000	0.00%
	2007 Options	30,113	-	0.00%	30,113	0.00%
	2010 Options	50,000	-	0.00%	50,000	0.00%
Gil Sharon (CEO of Pelephone)	Executive options	1,750,000	-	0.00%	1,750,000	0.06%

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26 "Executive Options" - options allotted under the options plan for senior managers and employees dated 2007 - see section **שגיאה! מקור ההפניה לא נמצא.**; " 2007 Options" - options allotted under employee options plan dated 2007 - see section 11B; "2010 Options" - options allotted under the employee options plan dated 2010 - see section 11.D.

27 Holdings below 0.01% are noted as 0.00%.

28 Shares held by Mrs. Iris Elovitch, wife of the indirect controlling shareholder and Chairman of the Board of Directors, Mr. Shaul Elovitch. Shares acquired prior to the transfer of control, during the course of 2006 and reported thus far under the B Communications Ltd. holdings Note.

Name of holder	Type of security[26]	Number of convertible NIS securities - ratio 1:1	Number of NIS 1 par value shares each	Rate of holding in votes and in equity [27]	Number of NIS 1 par value shares Fully diluted	Percentage of holding Fully diluted
Yitzhak Benbenisti (CEO of Bezeq International)	Executive options	833,333	-	0.00%	833,333	0.03%
Yuval Keinan (VP Engineering and Network)	Executive options	233,333	-	0.00%	233,333	0.01%
Ran Guron (VP Marketing)	Executive options	300,000	-	0.00%	300,000	0.01%
Itamar Harel (VP, Manager of Private Division)	Executive options	375,000	-	0.00%	375,000	0.01%
Eli Frank (VP IT)	Executive options	233,334	-	0.00%	233,334	0.01%
Eyal Kamil (VP Operations and Logistics)	Executive options	425,000	-	0.00%	425,000	0.02%
Yaakov Paz (VP, Manager of Business Division)	Executive options	300,000	-	0.00%	300,000	0.01%
Ehud Mezuman (VP Human Resources)	Executive options	233,334	-	0.00%	233,334	0.01%
	Ordinary shares		6,282	0.00%	6,282	0.00%
Sharon Fleischer Ben Yehuda (VP Regulation)	Executive options	233,334	-	0.00%	233,334	0.01%
David Mizrachi (VP Economics and Budget)	Executive options	300,000	-	0.00%	300,000	0.01%
Amir Nahlieli (VP and Legal Counsel)	Executive options	700,000	-	0.00%	700,000	0.03%
Guy Hadass (Company Spokesman)	Executive options	33,334	-	0.00%	33,334	0.00%

B. The Company's other securities

As at the date of the periodic report, 880,100,000 Debentures (Series 5) of the Company are held by the subsidiary, Bezeq Zahav (Holdings) Ltd.

C. Securities of a related company

As at the date of the periodic report, 15,015 DBS shares, constituting 50.22% of the issued equity are held by Eurocom DBS Ltd., a company indirectly controlled by Mr. Shaul Elovitch (the indirect controlling shareholder of the Company). For further information pertaining to trusteeship of these shares pursuant to the conditions of the regulatory approvals for the acquisition of control of the Company by B Communications, see section 1.3.1 of Chapter A of the periodic report - Description of the Company's Businesses.

11. Standard 24A: Registered capital, issued capital, and convertible securities

A. Registered equity and issued equity:

The Company's registered equity as at the date of the periodic report is 2,825,000,000 ordinary shares of NIS 1 par value each. The Company's issued and paid-up equity as at the publication date of the periodic report is 2,688,277,745 ordinary shares of NIS 1 par value each.

B. 2007 Employee Options Plan: under an outline dated February 22, 2007, 78,151,368 options were allotted to employees. These options are exercisable into ordinary shares of NIS 1 par value each of the Company (including 59,574 options allotted to two employee directors on January 2, 2008 under the private placement report dated October 29, 2007). As at the publication date of the periodic report, 63,121,004 options have been exercised into shares and the balance of unexercised options is 15,030,071.

C. The 2007 Options Plan for Managers and Senior Employees Under the options plan for managers and senior employees, which includes up to 65,000,000 options earmarked for exercise into up to 65,000,000 Company shares (less depreciation), as at the date of the periodic report 59,050,001 options, exercisable into ordinary shares of NIS 1 par value each of the Company, have been allotted. As at the publication date of the periodic report, 29,649,912 of these options have been exercised into shares and the balance of unexercised options is 29,400,089.

D. 2010 Employee Options Plan: In accordance with the employee options plan, which includes up to 70,000,000 shares of the Company of NIS 1 par value each (which includes 87,455 options allotted to two employee directors, on January 25, 2011 under a private placement report dated December 20, 2010), 67,552,269 options are exercisable into ordinary shares of NIS 1 par value each were allotted under an outline dated December 20, 2010. As at the publication date of the periodic report, options under this plan have not yet been exercised.

E. Treasury shares: The issued equity of the Company does not include treasury shares.

12. Standard 24B: Register of shareholders

The Company's Register of Shareholders is presented in this report by way of reference to the Company's statement of equity and from the registered securities of the Company and adjustments made on March 6, 2011 (pertaining to the appendix under section 4 of said statement).

13. Standard 25A: Registered address of the Company

Address: 132 Menachem Begin Avenue, Azrieli Center, (Triangle Tower), Tel Aviv

Telephone 1: 03-626-2200; Telephone 2: 03-626-2201; Fax:03-626-2209

Email: linoryo@bezeq.co.il (Company Secretary).

14. Standard 26: Directors of the Company

A. (1) Name: **Shaul Elovitch** I.D.:.042089367

(2) Date of birth: January 4, 1948

(3) Address for delivery of court notices: 2 Dov Friedman Street, Ramat Gan, 52503

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Chairman of the Board of Directors.

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Yes, see particulars below.

(8) Date of commencement of tenure: April 4, 2010

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

Chairman and owner of Eurocom Group.

The companies in which he serves as a director –

Pelephone Communications Ltd. – Chairman; Bezeq International Ltd. – Chairman; Bezeq Zahav (Holdings) Ltd. – Chairman; Walla! Communications Ltd; Bezeq Online Ltd. – Chairman; D.B.S. Satellite Services Ltd; Eurocom Holdings (1979) Ltd. – Chairman; Eurocom Communications Holdings 2005 Ltd; Eurocom Management Technologies (2005) Ltd.; Eurocom Properties Ltd.; Eurocom Property Holdings Ltd; Eurocom General Management Ltd.; Eurocom Holdings Management Ltd.; Eurocom Communications Ltd. - Chairman; Eurocom Cellular Communications Ltd. - Chairman; Eurocom Cellular Technologies (2000) Ltd.; Tapuz Cellular Systems Ltd.; Eurocom Industries (1986) Ltd. – Chairman; Eurocom Digital Communications Ltd. – Chairman; Trans-Global PTE Ltd. - Chairman; D.M. (3000) Engineering Ltd.; Radio Holdings E.U. Ltd. – Chairman; FM Radio Hashfala Ltd.; Radio Broadcasts Ltd. – Chairman; Space Communication Ltd.; Satcom Systems Ltd.; Gilat Satcom Ltd.; Gaya Com Ltd.; IP Planet Network Ltd.; Satlink Communication Ltd.; Internet Gold – Golden Lines Ltd. – Chairman; Internet Zahav International Ltd.; Internet Zahav International Holdings (2000) Ltd.; Eurocom Internet Zahav (1995) Ltd.; B Communications Ltd. – Chairman; B Communication (S.P. 1) Ltd.; B Communication (S.P. 2) Ltd.; Gold Mind Media Ltd. – Chairman; Gold Mind Limudim Ltd.; Eurocom Media-Net Holdings Ltd.; Eurocom Networks 21 Ltd.; Eurocom Networks and Technologies Ltd; Eurocom DBS Ltd. – Chairman; MNB Tulip Trustees (2002) Ltd.; Eurocom Holdings and Investment Ltd.; Eurocom Management and Investment 2005 Ltd.; E.G.R.E Ltd.; Eurocom Real Estate Ltd.; Mivnei Dolinger Construction and Investment Ltd.; Mivnei Dolinger (City Gate) Construction and Investment Ltd.; R.F. Investments and Promotion 1988 Ltd.; Continental – Construction & Investment Company – D.A. Ltd.; Eurocom Project Management (1990) Ltd.; Eurocom Development (1995), Ltd.; Ofek The New World, Ltd.; M.Z.N – R.B Trustees – Tulip (2002) Ltd.

Related to other interested parties in the Company: Father of Or Elovitch and father-inlaw of Orna Elovitch Peled who, inter alia, serve as officers in Bezeq and its subsidiaries and/or related companies. Furthermore, Shaul Elovitch is the brother of Yosef Elovitch, who is (through holdings) an interested party in Bezeq.

The Company considers the director as having accounting and financial expertise

814,211,545 Company shares, as aforesaid, are held by D.B. Communications (S.P. 2) Ltd., a private company registered in Israel, which is wholly owned and controlled by B Communications (S.P. 1) a private company registered in Israel.

B. Communications (S.P. 1) Ltd. is wholly owned and controlled by B Communications Ltd. ("B Com"), an Israeli public company whose shares are traded by way of dual listing on the Tel Aviv Stock Exchange Ltd. and the NASDAQ. ("TASE" and "NASDAQ").

The controlling shareholder in B Com is Internet Gold – Golden Lines Ltd. ("Internet Zahav"), an Israeli public company whose shares are traded by way of dual listing on the Tel Aviv Stock Exchange Ltd. and the NASDAQ, which holds 76.78% of the issued and paid-up share capital of B Com..

The balance of the issued and paid-up share capital of B Com is held by the public and, to the best of B Com's knowledge, by various interested parties in Clal Insurance Company Ltd. Group and Clal Finance Ltd. Group. Furthermore, Eurocom Communications Ltd. ("Eurocom Communications"), a private company controlled by Mr. Shaul Elovitch, is the owner and holder of 1.37% of the issued and paid-up share capital of B Com.

The controlling shareholder of Internet Zahav is Eurocom Communications, holding 73.83% of the issued and paid-up share capital of Internet Zahav. The balance of the issued and paid-up share capital of Internet Zahav is held by the public. Furthermore, Eli Holtzman, CEO of Internet Zahav and B Com, holds 0.90% of the issued and paid-up share capital of Internet Zahav.

Eurocom Communications is a private company whose interested parties are: A. Eurocom Holdings (1979) Ltd. which holds 50.33% of the issued and paid-up share capital of Eurocom Communications; Eurocom Holdings (1979) Ltd. is a private company owned by Mr. Shaul Elovitch who holds 80% of its ordinary shares and 75% of its management shares and his brother, Mr. Yosef Elovitch holds 20% of its ordinary shares and 25% of its management shares; B. Four private companies owned by Mr. Shaul Elovitch and his brother, Mr. Yosef Elovitch (at holdings of 80% and 20%, respectively) which hold 49% of the issued and paid-up share capital of Eurocom Communications; C. Mr. Shaul Elovitch, who holds 0.67% of the issued and paid-up share capital of Eurocom Communications.

It is noted that the Bezeq shares owned by B Communications (S.P. 2) Ltd., are held in trust by Poalim (Romema) Trustees Ltd., as trustee for B Communications (S.P. 2) Ltd as the owners on the one hand, and for entities who provided finance for the acquisition of the shares under a financing agreement dated February 11, 2010, as holders of a first ranking lien on the shares, on the other hand.

It is also noted that Ms. Iris Elovitch, the wife of Mr. Shaul Elovitch, holds 72,360 ordinary shares of Bezeq and 18,218 shares of Internet Zahav.

(10) Related to another interested party in the Company: Yes

Father of Or Elovitch, father-in-law of Orna Elovitch Peled.

(11) The Company considers the director as having accounting and financial expertise

B. (1) Name: **Yitzhak Edelman** I.D. 50066174

(2) Date of birth: July 7, 1950

(3) Address: 4 Duchifat Street, Tel Mond

(4) Citizenship: Israeli

(5) Membership on the Board of Directors Committees: Audit Committee, Balance Sheet Committee

(6) External director: Yes.

(7) Employee of the Company, subsidiaries, affiliates or of an interested party: No

(8) Commencement of tenure: February 1, 2008 (Mr. Edelman's tenure was extended for a further 3 years as of February 1, 2011).

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

BA (Accounting and Economics), Tel Aviv University

2005 – 2007 Deputy CEO and CFO at Ness Technologies Ltd.

1996 – 2005 – Director of Finance Division at Cellcom.

Director at:

(10) Related to another interested party in the Company: No

(11) The Company considers the director as having accounting and financial expertise and as an external expert director.

C. (1) Name: **Orna Elovitch Peled** I.D.:.028735587

(2) Date of birth June 8, 1971

(3) Address for delivery of court notices: 2 Dov Friedman Street, Ramat Gan, 52503

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: No.

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: No.

(8) Date of commencement of tenure: April 14, 2010.

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

B.Sc. majoring in Finance and Economics, New York Institute of Technology.

2001-2005: Senior Vice VP, McCann Erickson; 2005-2009: CEO, McCann Boutique.

(10) The companies in which he serves as a director – D.B.S. Satellite Services (1998) Ltd. and Bezeq International Ltd.

(11) Related to other interested parties in the Company: Wife of Mr. Or Elovitch, a director at the Company and daughter-in-law of Mr. Shaul Elovitch, the controlling shareholder (through holdings).

D. (1) Name: **Or Elovitch** I.D.:038475117

(2) Date of birth: May 24, 1976

(3) Address for delivery of court notices: 2 Dov Friedman Street, Ramat Gan, 52503

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Compensation Committee

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Yes, see particulars below.

(8) Date of commencement of tenure: April 14, 2010.

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

BA in Business Administration, College of Management; MBA majoring in Finance, City University of New York

Senior Vice President of Business Affairs and Investments for Eurocom Communications, Ltd. 2006-present; Chairman of the Board, Sahar Investments, Ltd. 2007-present; Chairman of the Board, Eurocom Capital Finance, Ltd. 2007-present; Chairman of the Board, Eurocom Capital Underwriting Ltd. 2009- present; Chairman of the Board, Satcom, Ltd. 2007-2008.

The companies in which he serves as a director – Or Elovitch serves as a Director of Pelephone Communications, Ltd.; DBS Satellite Services (1998), Ltd.; Walla Communications, Ltd. (alternate); Bezeq Online, Ltd.; Bezeq Gold Holdings, Ltd.; Space-Communications, Ltd.; Satcom Ltd.; Gilat Satcom, Ltd.; Gaya Com, Ltd.; IP Planet Network, Ltd.; Satlink Communications, Ltd.; B Communications (SP1); B Communications (SP2); Seret: The Israeli Portal Movies Portal, Ltd.; Gold Mind Limudim, Ltd.; Eurocom Capital Finance, Ltd. – Chairman; Eurocom Capital Underwriting Ltd. – Chairman; Smart Capital, Ltd.; Pilat Global Media PLC;– Chairman; E.G.R.E. Ltd

(10) Related to other interested parties in the Company: Or Elovitvch is the son of Shaul Elovitch the controlling shareholder in the Company and the husband of Orna Elovutch Peled who serves as a director of Company. Furthermore, Or Elovitch is the nephew of Yosef Elovitch, who is (through holdings) an interested party in Bezeq.

(11) The Company considers the director as having accounting and financial expertise

E. (1) Name: **Eldad Ben Moshe** I.D.:.058774290

(2) Date of birth June 8, 1964

(3) Address for delivery of court notices: 17 Bazelet Street, Shoham, 60850

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Committee for examining financial statements

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: No.

(8) Date of commencement of tenure: April 14, 2010.

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

B.A. in Accounting and Economics, Tel Aviv University; MBA, Tel-Aviv University and certified public accountant, Institute of Certified Public Accountants in Israel.

2008 – present – CEO of Inrom Industries Ltd. Group; 2008-2009 – CEO Grinstone Industries Ltd. and Inrom Industries Ltd.; 2003-2006 – CEO Nirlat Paints Ltd.; 2007 – present – Chairman of boards of directors of: Ytong, Ltd.; Module Building Industries, Ltd.; Alony Corporation, Ltd.; Orlite (Millennium) Ltd.; Ordan Metal Casting Industries, Ltd.; Nirlat Paints, Ltd. and director of Pelephone Communications Ltd.

(10) Related to other interested parties in the Company: None.

(11) The Company considers the director as having accounting and financial expertise

F. (1) Name: **Eliyahu Holtzman** I.D.:.003669587

(2) Date of birth: July 22, 1948

(3) Address for delivery of court notices: 8 Havradim Street, Kfar Sirkin, 49935

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Security Committee.

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Yes, see particulars below.

(8) Date of commencement of tenure: April 14, 2010.

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

B.Sc. Chemistry and Pharmacy, University of Illinois

CEO Internet Gold – Golden Lines, Ltd.; CEO, Gold Mind Media, Ltd.; CEO, B Communications, Ltd.

The companies in which he serves as a director – DBS Satellite Services (1998), Ltd.; Bezeq International, Ltd.; Bezeq Online, Ltd.; Internet Gold – Golden Lines, Ltd.; Gold Mind Media, Ltd.; Gold Mind Limudim, Ltd.; Nirshamin Lelimudim, Ltd.: Seret: The Israeli Movies Portal, Ltd.; Hype Active Media, Ltd. and Start Net, Ltd.

(10) Related to other interested parties in the Company: None.

(11) The Company does not consider the director as having accounting and financial expertise

G. (1) Name: **Felix Cohen** I.D.:.26809806

(2) Date of birth: December 14, 1953

(3) Address for delivery of court notices: 2 Dov Friedman Street, Ramat Gan, 52503

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Is not a member of the Board of Directors Committees:

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Yes, see particulars below.

(8) Date of commencement of tenure: April 14, 2010.

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

CFO of Eurocom Group.

The companies in which he serves as a director – Bezeq International, Ltd.; Bezeq Online, Ltd.; Internet Gold – Golden Lines, Ltd.; E.G.R.E, Ltd.; D. M. (3000) Engineering, Ltd.; Sahar Investments, Ltd.

(10) Related to other interested parties in the Company: None.

(11) The Company considers the director as having accounting and financial expertise

H. (1) Name: **Rami Nomkin** I.D:.042642306

(2) Date of birth January 14, 1949

(3) Address for delivery of court notices: 129 Mohaliver Street, Yahud

(4) Citizenship: Israeli

(5) Membership on the Board of Directors Committees: Committee for examining financial statements

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: The director serves as the head of the Company's sales department.

(8) Commencement of tenure:.17/01/2007

(9) Occupation during past five years:

Education: High School

From 2009, manager of Bezeq's sales department; From 2001 – manager of business center at Bezeq Business;

(10) Related to other interested parties in the Company: None.

(11) The Company does not consider the director as having accounting and financial expertise

I. (1) Name: **Arieh Saban** I.D: 064902083

(2) Date of birth: May 2, 1947

(3) Address for delivery of court notices: 59 Kaplan Street, Herzlia

(4) Citizenship: Israeli

(5) Membership on the Board of Directors Committees: No.

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: No.

(8) Date of commencement of tenure:.11/10/2005

(9) Education and employment during the past five years and details of the companies in which he serves as a director: For 15 years distributed and marketed children's television programs through Israel Audio Visual Corp.

(10) Related to other interested parties in the Company: None.

(11) The Company does not consider the director as having accounting and financial expertise

J. (1) Name: **Yehuda Porat** ID: 05976945

(2) Date of birth February 18, 1968

(3) Address for delivery of court notices: 2 Mevo Haro'im, Har Adar 90836

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Security Committee

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Manager of the Security, Safety and Emergency Department of the Company.

(8) Date of commencement of tenure: January 1 7, 2007

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

LL.B., Kiryat Ono Academic College; Practical Electronic Engineer, Bezeq College, Jerusalem; Member of the Israel Bar Association; Bugging Location and Detection course given by an external advisor to the Security Services; Bugging Detection course – R.E.I., USA; Basic Data Protection for Security Officers course – Israel Security Agency (ISA); Interrogation course – ISA; IT Systems Security – ISA; Critical computer systems security course – ISA; Advanced course in protecting computerized systems from information warfare – ISA ; Directors in Private and Public Companies course - The Israeli Center for Management; Advanced Directors course - The Israeli Center for Management; Analysis of Financial Reports and Corporate Value Assessment course - The Israeli Center for Management; Qualified Mediator course – Israel Bar Association

Occupation during past five years: 1999-2007 Manager of Bezeq's Bugging Detection and Special Jobs Department; 2007-present Manager of Bezeq's Security, Safety and Emergency Department

(10) The companies in which he serves as a director – None.

(11) Related to other interested parties in the Company: None.

K. (1) Name: **Mordechai Keret** I.D.: 054759915

(2) Date of birth: May 7, 1957

(3) Address for delivery of court notices: 12 Hanurit Street, Tel Mond .

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Audit Committee – Chairman; Committee for examining financial statements – Chairman; Compensations Committee – Chairman; Security Committee

(6) The director is an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: No.

(8) Date of commencement of tenure: February 4, 2010

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

CPA - BA in Accounting and Finance, Tel Aviv University

Occupation during past five years: Since 2002, CEO and owner of consulting and investment firm, Keret Management and Holdings; 7/2008-9/2009, Chairman, Board of Directors, Gmul Investment Company; 12/2007-7/2009, Director, Gmul Investment

Company. 2007-2/2008, Chairman, Board of Directors, Multimatrix, Ltd.; 2000-7/2007, Director, Shikun & Binui, Ltd.; 1998-9/2007, Director, Gain Holdings, Ltd.; 1993-2006, Senior Vice President CFO, Arison Investments, Ltd.; 12/2007-7/2009, Director, Gmul Real Estate, Ltd.;

The companies in which he serves as a director – Director of TIA Investments – external director, Priortech Ltd., ISSTA Lines, Ltd

(10) Related to other interested parties in the Company: No.

(11) The Company considers the director as having accounting and financial expertise and as an external expert director.

L. (1) Name: **Amikam Shorer** I.D: 059821983

(2) Date of birth: July 27, 1967

(3) Address for delivery of court notices: 2 Dov Friedman Street, Ramat Gan, 52503

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Compensations Committee and Security Committee

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Yes, see particulars below.

(8) Date of commencement of tenure: April 14, 2010.

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

BA LLB, Bar Ilan University

Occupation during past five years: Senior Vice President for Business Affairs,; Eurocom Communications, Ltd.; CEO and Director, Sahar Investments, Ltd.; Chairman; and Director, Satcom Systems, Ltd. (CEO 2007-2008).

The companies in which he serves as a director – Pelephone Communications, Ltd.; DBS Satellite Services (1998), Ltd.; Bezeq Online, Ltd.; Bezeq Zahav (Holdings), Ltd.; Walla Communications, Ltd. (alternate); Space- Communication, Ltd.; Satcom Systems, Ltd.; Gilat Satcom, Ltd.; Gaya Com, Ltd.; IP Planet Network, Ltd.; Satlink Communications, Ltd.; Internet Gold – Golden Lines, Ltd.; B Communications (SP1); B Communications (SP2); Gold Mind Limudim, Ltd.; Eurocom Capital Underwriting, Ltd.; Sahar Investments, Ltd.; E.G.R.E, Ltd.; IP Planet Network Ltd. and IP Planet Communications, Ltd.

(10) Related to other interested parties in the Company: None.

(11) The Company does not consider the director as having accounting and financial expertise

M. (1) Name: **Shlomo Rodav** ID: 030596860

(2) Date of birth: October 27, 1949

(3) Address for delivery of court notices: 5 Kerem Hazeitim St., Saviyon

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: No

(6) The director is not an external director.

(7) Employee of the Company, a subsidiary, related company or interested party: Yes .He terminated his terms as Chairman of the board of directors on December 31, 2010 and is expected to terminate his employment on June 2, 2011 (at the end of the prior notice period in accordance with his employment agreement).

(8) Date of commencement of tenure: September 4, 2007

(9) Education and employment during the past five years and details of the companies in which he serves as a director:

BA (Economics), Tel Aviv University; MBA, Columbia University.

Employment during the past five years and details of the companies in which he serves as a director:

2011 – Director at Bezeq

2007 – 2010 – Chairman of Bezeq Board of Directors; Chairman of boards of directors of Pelephone, Bezeq International, Bezeq Online, Walla, director of DBS.

2003-2005 – chairman of the board of directors and CEO (2004-2005) of Gilat Satellite Networks Ltd.

1990-2007 – CEO and/or director and/or chairman of the board of directors of Kror Holdings Ltd. / Yafaora-Tavori Ltd. / Yafaora Ltd. / Tefogen Industries Ltd. / Whist Management Israel Ltd. / InirU Israel Ltd. / InirU Wireless Inc. / the Israel Shipping & Supply Corporation Ltd. / Nimphaea A.A. Ltd. / Turel Investments Ltd. Since August 2007, not acting as CEO and/or chairman of the board of directors of any of the above companies.

(10) Related to other interested parties in the Company: No.

(11) The Company considers the director as having accounting and financial expertise

N. (1) Name: **Yehoshua Rosenzweig** ID: .013841069

(2) Date of birth: August 17, 1952

(3) Address for delivery of court notices: c/o Rosenram, 52 Menachem Begin Avenue, Tel Aviv, 67137.

(4) Citizenship: Israeli

(5) Membership on Board of Directors Committees: Committee for examining financial statements and Audit Committee.

(6) The director is an independent director.

(7) Employee of the Company, a subsidiary, related company or interested party: No.

(8) Date of commencement of tenure: November 22, 2010

(9) Education: LL.B, Bar Ilan University; LL.M and LL.D, New York University.

Occupation during past five years: Since 2005, advocate at Rosenzweig & Aviram law firm; 2003 – 2006, Chairman of First International Bank; since 2005, founder and director in Rosenram Business Development Investment House Ltd.; since 2009, Chairman of the Executive Committee of Bar Ilan University; Keren Matana – committee member, Harmonia – committee member.

The companies in which he serves as a director – Rosenram Business Development Ltd., Rosenram; Trust Co. Ltd., Rosenzweig Legal Services Ltd., Waterfall Solutions Ltd. – Chairman of the Board,; Keren Mor International Real Estate Ltd.; Rosetta Genomics Ltd.; Gita Technologies Ltd. – Chairman of the Board; Solarpower Systems Ltd. – Chairman of the Board, Alrov Real Estate & Hotels Ltd.; Tzohar Simulation Investments Ltd., Babua Advanced Sciences Ltd., Babua Simulation Investments (1996) Ltd.;

(10) Related to other interested parties in the Company: None.

(11) The Company considers the director as having accounting and financial expertise

15. Standard 26A: Senior officers in the Company

A. (1) Name: **Avraham Gabbay** ID:59777920

(2) Date of birth:22/02/1967

(3) Serves in this position since:14/11/2007

(4) The office he holds in the Company: CEO

(5) Is he a family member of another senior officer or of an interested party: Yes. Interested party in the Corporation by virtue of his service as Company CEO.

Education and business experience over the past five years:

BA in Economics, Hebrew University

MBA, Hebrew University

6/07-11/07 – Acting CEO of Bezeq, The Israel Telecommunications Corp. Ltd.

7/03-6/07 – CEO Bezeq International

B. (1) Name: **Ran Guron** ID:024113268

(2) Date of birth: December 25, 1968

(3) Serves in this position since: January 9, 2006

(4) The office he holds in the Company: VP Marketing

(5) Is he a family member of another senior officer or of an interested party: No

(6) Education and business experience over the past five years:
BA Economics and Business Administration, Hebrew University
MBA, Hebrew University

C. (1) Name: **Alan Gelman** ID:015704307
(2) Date of birth: 05/11/1955
(3) Serves in this position since:15/02/2008
(4) The office he holds in the Company: CFO and Deputy CEO
The position that he holds in a subsidiary of the Company, a related company or an interested party:
Director of: Pelephone Communications Ltd.; Walla! Communications Ltd.
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
B A., Queens College, New York
MBA, Hofstra University, New York
Certified Public Accountant in Israel
CPA in the State of New York
2006-2007 – CFO and Deputy CEO of Delek Group
2001-2006 – CFO at Partner Communications Ltd.

D. (1) Name: **Guy Hadas** ID:029654472
(2) Date of birth:08/09/1972
(3) Serves in this position since:9/12/2007
(4) The office he holds in the Company: Company spokesperson
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
BA in Economics and Media, Tel Aviv University
MBA, Tel Aviv University
2002 – 2007 – Globes [Israeli financial newspaper] journalist

E. (1) Name: **Itamar Harel** ID:028054666
(2) Date of birth: October 18, 1970
(3) Serves in this position since: October 25, 2007
(4) The office he holds in the Company: VP, Manager of Private Division
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
MBA in Marketing and Accounting, Hebrew University
2002-2007 – Manager of Private Marketing Department and Manager of Private and Medium and Small Business Sales and Services Department at Bezeq

F. (1) Name: **Linor Yochelman** ID:032037939
(2) Date of birth: February 11, 1975
(3) Serves in this position since: August 19, 2007
(4) The office he holds in the Company: Company Secretary
The position that he holds in a subsidiary of the Company, a related company or an interested party:
Company secretary of subsidiaries: Bezeq International Ltd.; Bezeq Online Ltd.; Bezeq Zahav Holdings Ltd.
(5) Is she a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
BA Business Administration, Interdisciplinary Center, Herzliya
LL.B, Interdisciplinary Center, Herzliya

2004-2007 Company secretary of The Phoenix Group

G. (1) Name: **Ehud Mezuman** ID:052176336

(2) Date of birth: February 17, 1954

(3) Serves in this position since:25/10/2007

(4) The office he holds in the Company: VP Human Resources

(5) Is he a family member of another senior officer or of an interested party: No

Education and business experience over the past five years:

3 years studies at Tel Aviv University – Social Sciences (no degree)

2005-2007 – Deputy VP Human Resources and Director of Management Development Department

2001-2005 – Director of Management Development & Training Department, Bezeq

H. (1) Name: **Dudu Mizrachi** ID:024810368

(2) Date of birth: January 28, 1970

(3) Serves in this position since: June 28, 2007

(4) The office he holds in the Company: VP Economics & Budgets

(5) Is he a family member of another senior officer or of an interested party: No

(6) Education and business experience over the past five years:

BA Economics, Hebrew University in Jerusalem

2000-2007 – Director of Regulations Department at Bezeq

I. (1) Name: **Amir Nachlieli** ID:23012313

(2) Date of birth: May 30, 1967

(3) Serves in this position since: January 1, 2009

(4) The office he holds in the Company: VP, Legal Counsel

(5) Is he a family member of another senior officer or of an interested party: No

Education and business experience over the past five years:

2007 – 2008 – Legal adviser to Colmobil Ltd.

2005 – 2006 – YaGusa Technology business development

MBA (expanded major in Finance), Tel Aviv University

BA Economics, Hebrew University

LL.B, Hebrew University

J. (1) Name: **Danny Oz** ID:054299953

(2) Date of birth: June 16, 1956

(3) Serves in this position since: September 1, 1998

(4) The office he holds in the Company: Accountant and deputy CFO

(5) Is he a family member of another senior officer or of an interested party: No

(6) Education and business experience over the past five years:

BA Economics & Accounting, Hebrew University, Certified Public Accountant's License

EMBA – Integrative Administration, Hebrew University

Since September 1998 – Company Accountant

K. (1) Name: **Yaakov Paz** ID:058610999

(2) Date of birth: October 21, 1963

(3) Serves in this position since: November 1, 2007

(4) The office he holds in the Company: VP, Manager of Business Division

(5) Is he a family member of another senior officer or of an interested party: No

(6) Education and business experience over the past five years:

Since 2006 – Chairman of board of directors of Alcatel Telecom Israel Ltd.

2006 – CEO, DoubleU Advanced Mobile Solutions

2002-2006 – CEO and Chairman of Alcatel Telecom Israel Ltd.

L. (1) Name: **Sharon Fleischer Ben Yehuda** ID:028531648
(2) Date of birth: April 25, 1971
(3) Serves in this position since: June 1, 2006
(4) The office he holds in the Company: VP Regulation
(5) Is she a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
BA Political Science, , Hebrew University in Jerusalem
MA Public Policy and Administration, Hebrew University
Until May 31, 2006 – VP Regulation at Pelephone Communications Ltd.

M. (1) Name: **Eli Frank** ID:053337739
(2) Date of birth: July 6, 1955
(3) Serves in this position since: September 19, 2006
(4) The office he holds in the Company: VP Information Systems
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
MBA, Tel Aviv University
BA Mathematics and Computer Science, Bar Ilan University
Professional qualifications (Programming, Systems Analysis, etc.) Mamram [IDF Central Computing Facility
Since 2004, information strategy and management consultant (freelance)

N. (1) Name: **Yuval Keinan** ID:032089245
(2) Date of birth:23/02/1975
(3) Serves in this position since:01/08/07
(4) The office he holds in the Company: VP Engineering and Networks Division
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
BA Computer Science, Merci College
2005-2007 – VP Information Technologies (Engineering and Information Systems) at Bezeq International Ltd.
2003-2005 – Director, Engineering Operations, Bezeq International Ltd.

O. (1) Name: **Eyal Kamil** ID:057248999
(2) Date of birth:30/08/1961
(3) Serves in this position since:05/12/06
(4) The office he holds in the Company: VP Operations & Logistics
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
BA, Industrial Engineering & Management, Tel Aviv University
MBA, Tel Aviv University
2005 – December 4, 2006 – Manager, Change Administration, Bezeq

P. (1) Name**: Lior Segal** ID:025695701
(2) Date of birth:09/09/1973
(3) Serves in this position since:24/01/11
(4) The office he holds in the Company: Internal Auditor
(5) Is he a family member of another senior officer or of an interested party: No
(6) Education and business experience over the past five years:
BA, Industrial Engineering & Management, Tel Aviv University
MBA, Tel Aviv University

2005 – December 4, 2006 – Manager, Change Administration, Bezeq

Pelephone Communications Ltd.

Q. (1) Name: **Gil Sharon** ID:058381351

(2) Date of birth:12/09/1963

(3) Serves in this position since:11/10/05

(4) The office he holds in the Company: CEO of subsidiary, Pelephone Communications Ltd.

(5) Is he a family member of another senior officer or of an interested party: No

(6) Education and business experience over the past five years: MBA, Tel Aviv University; LL.B, Tel Aviv University; BA Accounting, Tel Aviv University; Diploma – Accounting, Tel Aviv University, Israeli license to practice law; Certified Public Accountant in Israel; participated in IMC diploma course in Internal and Public Auditing; Corporate Governance Compliance Officer at Bezeq from 2010 until appointment as internal auditor; Manager of internal audit process at Bezeq from 2009 until appointment as internal auditor; 2007-2008 Accountant – Alut Communications Ltd.; 2005-2007, Manager of Revenue Assurance and SOX Division – Partner Communications, Ltd.

Bezeq International Ltd.

R. (1) Name: **Yitzhak Benbenisti** ID:059146415

(2) Date of birth: 21/01/65

(3) Serves in this position since: 01/11/2007

(4) The office he holds in the Company: CEO of the subsidiary, Bezeq International Ltd.

(5) Is he a family member of another senior officer or of an interested party: No

(6) Education and business experience over the past five years:

BA Economics, Hebrew University

MBA (expanded major in Finance and Marketing), Hebrew University

May – November 2007 – acting CEO at Bezeq International Ltd.

2003-2006 – Hewlett Packard Israel, director and CEO of PC and distribution channel division

The Company has no independent authorized signatories.

Below are the names of the senior officers who completed their term of service during the course of 2010 and by the date of publication of the periodic report for 2010:

Officers

Malka Dror - Internal Auditor of the Company terminated her service on December 2, 2010.

The following directors terminated their service on date of transfer of control in the Company (April 14, 2010):

Adam Chesnoff, K.Kiarie, Michael Grabiner, Stephen Grabiner, Yoav Rubenstein Menachem Inbar,, David Gilboa, Alon Shalev, Ran Gottfried, Zehavit Cohen.

The external director, Mr. Eyal Yaniv terminated his term of service in the Company on January 31, 2010.

16. Standard 26B: Independent authorized signatory

The Company has no independent authorized signatories.

17. Standard 27: The auditors of the Company

Somekh Chaikin, Certified Public Accountants

Address: 17 Ha'arba'a St.

Millennium Tower KPMG

Tel Aviv, 64739

Tel:03-6848000

18. Standard 28: Changes in the Memorandum or Articles of Association

A. On February 4, 2010 articles 85.1, 88 and 103.1 were amended, becoming effective on August 31, 2010, as set forth in section 16.2 below.

B. On December 16, 2010, as part of increasing the Company's registered equity to 2,825,000,000 shares of NIS 1 par value each, the Company's Articles of Association and Memorandum were amended accordingly.

19. Standard 29(A): Recommendations and resolutions of the Board of Directors before the General Meeting and their resolutions which are not subject to the approval of the General Meeting

A. Resolution of March 23, 2009 – (a) to recommend to the General Meeting of shareholders of the Company to approve distribution of a cash dividend in the total amount of NIS 2,453 million; (b) to recommend that the General Meeting of shareholders of the Company approve a bonus in the amount of NIS 3,244,935 (which is approximately 150% of his annual salary) for Mr. Shlomo Rodav, which is the maximum annual bonus under his employment contract, and as was approved by the General Meeting of the Company on June 1, 2008; (c) to recommend that the General Meeting of shareholders approve a bonus for Mr. Yehuda Porat for 2009 in the amount of NIS 90,000, for compliance with goals and based on administrative recommendation.

B. Resolution of August 2, 2010 – to recommend to the General Meeting of shareholders of the Company to pay the shareholders of the Company a cash dividend in the total sum of NIS 1,280 million.

C. Resolution of December 30, 2010 – to suggest to the general meeting of the Company's shareholders to approve a dividend to the Company's shareholders in a total amount of NIS 3 billion, the amount of the surplus profits of the Company, as defined in section 302 of the Companies Law, in six equal six-monthly installments during the course of 2011-2013 and subject to the approval of the court for the dividend.

D. Resolution of March 7, 2011 – to recommend to the General Meeting of shareholders of the Company to distribute to the shareholders of the Company a cash dividend in the total sum of NIS 1,163 million. The dividend is subject to the approval of the general meeting of the Company's shareholders.

E. Resolution of November 22, 2010 – not to approve the amendment to Article 131 of the Company's articles of association.

F. Regarding extraordinary transactions, see sections 9 above and 21 below.

20. Standard 29(C): Resolutions adopted at an Extraordinary General Meeting (EGM)

A. Approval of the appointment and terms of service of Mordechai Keret as an external director, and to provide a writ of undertaking to indemnify, as an external director, for a period of three years (Resolution of February 4, 2010).

B. Approval of the amendment to the Company's Articles of Association (articles 85.1' 88 and 103.1), as follows:

1. At the end of Regulation 85.1, the following words will be added: “Notwithstanding the foregoing, the current serving directors may, at any time, and from time to time, appoint as a director (who is not an external director) any person who is qualified to be appointed as a director in accordance with Section 224A of the Companies Law, in order to fill a place that becomes vacant for any reason and as long as the number of directors at any time does not exceed the existing number prior to the amendment. A director appointed as aforesaid will serve for a period of no more than 90 days from date of appointment or until the next regular General Meeting when he can be elected.”

2. Regulation 88 will be changed and replaced by the following text: “The Board of Directors of the Company may continue working even if there is a vacancy on the board as long as the number of directors does not drop below the minimum. If the number of directors drops below the minimum number, the remaining Board of Directors may not act unless to appoint additional directors as stated in the last section of Regulation 85.1 and/or in order to convene at the earliest possible time a General Meeting for the purpose of appointing additional directors. During the interim period, until additional directors are appointed as stated, the Board of Directors may act for any purpose that is critical and urgent for the Company’s benefit, but not for other purposes.”

3. Regulation 103.1 of the Articles of Association will be amended, so that instead of the words “three classified Directors”, it will now read, “three or four classified Directors" (This amended resolution became effective after receipt of the approval of the Minister of Communications as required under the Company's articles of association).

C. Approval of the transaction to acquire a run off policy for the Company's officers' liability insurance (Resolution of March 8, 2010 – see particulars in section 9.C.7 above).

D. Approval of the distribution of a cash dividend to the Company's shareholders in the amount of NIS 2,453 million. (Resolution dated April 8, 2010).

E. Approval of a bonus for the Chairman of the Board of Directors in the amount of NIS 3,444,480 (Resolution dated April 8, 2010).

F. (a) Approval of DBS debt settlement. (b) Approval of the settlement agreement with the former CEO of the Company, Mr. Yaakov Gelbard. (Resolution dated May 20, 2010 – see sections 9.C.1 and 2 above)).

G. (a) Approval of the Company's agreement with Eurocom Communications Ltd. to provide ongoing management and consultancy service to the Company (see section 9.C.3. above); (b) Providing a prior undertaking of indemnification for the Company's new directors: Messrs Or Elovitch, Orna Elovitch-Peled, Shaul Elovitch, Eldad Ben Moshe, Eli Hotzman, Felix Cohen and Amikam Shorer (see section 9.C.8 above); (c) Approval of the subsidiary, Pelephone engaging in an agreement with Eurocom Cellular Communications Ltd. to arrange the purchase and supply of Nokia products (terminal equipment, spare parts and accessories) to Pelephone and provision of maintenance services for these products – see section 9.C.4 above. (Resolution dated June 10, 2010).

H. Approval of the vote at the general meeting of shareholders of DBS in favor of the agreement between DBS and Advanced Digital Broadcast S.A. and Eurocom Digital Communications Ltd. for the purchase of 47,500 yesMaxHD converters and for USD suppliers credit for an additional period of 60 days from Eurocom, with regard to the purchase of converters – see section 9.C.9 above. (Resolution of July 29, 2010).

I. Approval of the distribution of a cash dividend to the Company's shareholders in the amount of NIS 1,280 million. (Resolution dated September 12, 2010).

J. (a) Approval of the Company's agreement with DBS to amend the debt settlement of May 2010 and of September 2006. (b) Approval of the agreement between Bezeq International and the Company to amend the debt settlement of January 2010 – see section 9.C.1 above; (c) Approval of the Company's engagement in an agreement with DBS to authorize DBS to sell wireless routers to its customers - see section 1.C.1 above; (d) Approval of arrangement between the Company and DBS for mutual marketing of products and services – see section 9.C.6 above; (e) Approval of arrangement between the Bezeq International and DBS for mutual marketing of products and services – see section 9.C.6 above. (Resolution dated October 14, 2010).

K. (a) Approval of the appointment and terms of service of Yehoshua Rosenzweig as an independent director, including a writ of undertaking to indemnify. (b) Approval of money compensation to the employee directors, Rami Nomkin and Yehuda Porat for the delay in allotting options to them from the employee options plan of 2007. (c) Approval for continuing the liability insurance policy for directors and officers, which was approved by the Company's Audit Committee and Board of Directors (on January 24, 2010 and January 28, 2010, respectively), under the "framework agreement" that was valid until October 10, 2010. Accordingly, to approve the continuation of the foregoing policy from that date until the end of the current policy, until April 13, 2011 (See particulars in section 22). (Resolution dated November 22, 2010) – see section 9.C.9 above.

L. Approval to increase the Company's registered equity by 76,000,000 ordinary shares of NIS 1 par value each, which will be equal in all their rights to the ordinary shares of NIS 1 par value each of the Company, so that together with the current registered equity balance, the total registered equity of the

Company will be 2,825,000,000 ordinary share of NIS 1 par value each, and to accordingly amend the Memorandum and Articles of Association of the Company. (Resolution dated December 16, 2010).

M. Approval of the allotment of options (and shares deriving from their exercise) to the Company's employees under the employee options plan (as set forth in the Company's immediate report dated December 20, 2010), under which up to 70,000,000 options, exercisable into 70,000,000 ordinary shares of NIS 2 par value each. (Resolution dated January 11, 2011).

N. Approval of distribution to the Company's shareholders amounting to a total of NIS 3 billion, which amount is in excess of the Company's profits, as defined in section 302 of the Companies Law, in six equal six-monthly installments during the course of the period 2011-2013, and subject to the court's approval of the distribution. (Resolution dated January 24, 2011).

O. Approval of the allotment of options to employee directors (as part of their eligibility to receive options as Company employees) under the Company employees' options plan and in accordance with an outline and private placement report dated December 20, 2010. (Resolution dated January 25, 2011).

P. Approval of the appointment of Mr. Yitzhak Edelman as an external director in the Company for a period of three additional years as of February 1, 2011 through January 31, 2014. (Resolution dated January 27, 2011).

21. Standard 29A (1) – (3): Transactions requiring special approval (extraordinary transactions)

A. On March 2, 2010 the board of directors approved granting bonuses for 2009 to the Chairman of the board of directors, CEO of Pelephone and CEO of the Company as set forth in section 7 above and for granting of bonuses to the VP Private Division (NIS 410,000), CFO (NIS 410,000), VP Human Resources (NIS 370,000) and VP Engineering and Networks (NIS 370,000). The payment of the bonus to the Chairman of the Board of Directors was approved by the general meeting of the Company's shareholders on April 8, 2010.

B. On December 2, 2010, the board of directors approved granting a special retirement bonus in the amount of NIS 200,000 to Ms. Malka Dror, the internal auditor of the Company, upon termination of her tenure at this date (in addition to the retirement terms she is entitled to under her employment contract).

C. On December 30, 2010 the board of directors adopted a compensations plan for senior managers in the Company and the subsidiaries, Pelephone Communications Ltd. and Bezeq International Ltd., which includes allotting of phantom options, updating the CEO's salary and amending the goal-based bonus formal for senior officers in the Company, as set forth in the Company's immediate report of the same date.

D. On March 3, 2011 the board of directors approved granting bonuses for 2010 to the Chairman of the board of directors, CEO of the Company, CEO of Pelephone Communications Ltd. and CEO of Bezeq International as set forth in section 7 above. Payment of the bonus to the Chairman of the board of directors requires the approval of the Company's general meeting.

22. Standard 29A (4): Liability insurance for directors and officers and indemnity obligations for officers

A. Insurance

1 The resolution of the Company's general meeting dated May 16, 2005 regarding approval of the exercise of an option for the purchase of a run-off policy covering the liability of officers who served in the Company until the date of transfer of control in the Company to Ap.Sb.Ar, i.e. on October 11, 2005, for a period of seven years from said date

2 The resolution of the Company's general meeting dated December 26, 2007 concerning the approval of a "framework transaction" for the Company's engagement, during the normal course of business, in future insurance policies to cover the liability of directors and officers as may be from time to time, including directors and officers who are or who are likely to be considered controlling shareholders in the Company, all the officers in companies in which the Company holds 50% or more, officers representing the Company in companies in which the Company holds 50% or more, and senior employees who are not officer, for managerial actions taken by them, and all by way of a "framework transaction" as defined in the Companies Regulations (Reliefs in Transactions with an Interested Party), 5760-2000 ("the Relief Regulations"), at an

annual premium of up to USD 510,000 plus a sum constituting up to 20% of that premium in respect of the current insurance cover.

3 The resolution of the Company's general meeting dated January 28, 2010 concerning an agreement to purchase an officers' insurance policy, under the framework agreement that was approved by the general meeting of the Company's shareholders on December26, 2007, from the expiry date of the of the ongoing directors' and officers' liability policy (the date of transfer of control from Ap.Sb.Ar. to B Communications as set forth in the immediate report issued by the Company on January 31, 2010 pertaining to the convening of a general meeting), and through to October 10, 2010. See section 9.C.9 above.

4 The resolution of the Company's general meeting dated January 28, 2010, which was approved by the general meeting of the Company's shareholders on March 8, 2010, concerning the conversion of the directors' and officers' insurance policy in the Company to a run-off29 policy. See section 9.C.7 above.

5 The resolution of the Company's general meeting of October 14, 2010 which was approved by the general meeting of the Company's shareholders on November 22, 2010, approving the purchase of a liability insurance policy for the current directors and officers in the Company and which was approved by the audit committee and the Company's board of directors (on January 24, 2010 and January 28, 2010, respectively. See section 9.C.9 above.

6 The decision of the Company's Board of Directors dated March 7, 2011, which has not yet been approved by the general meeting of the shareholders of the Company, pertaining to the Company purchasing, during the regular course of business, future insurance policies to cover liability of directors and officers, as they may be from time to time, including directors and officers who are and who may be considered to be controlling shareholders in the Company, and all by way of a framework transaction, as this is defined in the Relief Regulations, at an annual premium of USD 185,000 plus a sum constituting up to 20% of that premium in respect of the current insurance cover (and as specified above) and with liability limit of USD 100 million per claim and in total for the insurance period for legal expenses in Israel only.

7 The decision of the Company's board of directors, which has not yet been approved by the general meeting of the Company's shareholders concerning an agreement to purchase a D&O insurance policy from April 14, 2011 through to April 13, 2012. The annual premium that the Company will pay is USD 185,000. The liability limit is USD 100 million per claim and in total for each insurance year, and up to USD 20 million per claim or in total for the insurance period for legal expenses in Israel only Furthermore, the accumulative liability limit for subsidiaries is half of this amount (as part of the above liability limit). See section 9.C.11.

B. Indemnification obligation

The resolution of the Company's general meeting dated January17, 2007, concerning approval of a deed of indemnification all officers in the Company, for any liability or expense imposed on the officers due to their actions in their capacity as an officer in the Company (including their actions in subsidiaries), within the limitations provided under the Companies Law. The total amount of the indemnity was limited to a ceiling of 25% of the equity of the Company as may be at the time of actually paying the indemnity. The deed of indemnification shall apply to the list of types of occurrences, which was attached to the immediate report pertaining to the convening of the general meeting to approve the deed of indemnification. During 2007 – 2008 and until the date of publication of this report, an undertaking to indemnify was also approved for new officers who joined the Company.

It should be noted that in addition to the foregoing deeds of indemnification, in the past seven years the Company has undertaken to indemnity officers for the following instances:

A. An advance undertaking to indemnify for any expense or financial liability which is imposed on an officer following a proceeding filed against him in respect of the Company's prospectus from May 2004.

[29] to cover the liability of directors and officers as may be from time to time, including directors and officers who are or may be considered controlling shareholders in the Company, all the officers in companies in which the Company holds 50% or more, officers representing the Company in companies in which the Company holds 50% or more, and senior employees who are not officers, for managerial actions taken by them.

B. An advance undertaking to indemnify Company officers who served in the Company at the time the undertaking to indemnify was made or who were in office during the seven years preceding that date, for any expense or financial liability imposed on an officer due to a claim by a shareholder who held, at any time during the fours years preceding the date on which the undertaking to indemnify was given, 15% and more of the issued share capital of the Company.

C. An undertaking to indemnify to Company officers who served in the Company at the time an undertaking to indemnify was made or who were in office during the seven years preceding that date, to grant a loan for financing reasonable litigation expenses in a proceeding in which an officer is sued by another person, including a derivative action. The loan will become a grant if a competent court does not impose liability on the officer in a rule absolute.

D. The grant of an undertaking to officers that the insurance cover for events covered by an officers' insurance policy, which the Company purchased in July 2003, will be maintained for seven years, provided that the cost of the insurance premium is reasonable.

E. An undertaking to indemnify dated April 6, 2005 for financial liability imposed on Company officers for reasonable litigation expenses incurred by them in all matters pertaining directly or indirectly to a sale of State holdings in the Company.

F. An undertaking dated May 16, 2005 to indemnify Company offers who were in office during the seven years preceding the date of completion of the sale of the controlling core of the Company to Ap. Sb. Ar.

Date	Bezeq The Israel Telecommunication Corporation Ltd.

Names and titles of signatories:

Shaul Elovitch, Chairman of the Board of Directors

Abraham Gabbay, CEO

CHAPTER E – ANNUAL REPORT ON THE ASSESSMENT OF THE BOARD OF DIRECTORS AND MANAGEMENT OF THE EFFICACY OF INTERNAL AUDITING

Declaration of Managers

Declaration of the CEO

I, Avraham Gabbay, declare that –

(1) I have reviewed the Periodic Report of Bezeq, The Israel Telecommunications Corp. Ltd. ("Bezeq") for 2010 ("the Reports");

(2) To my knowledge, the Reports do not contain any incorrect representation of a material fact, nor is any representation of a material fact omitted which is needed to prevent the representations contained in them, in light of the circumstances in which they were included, from being misleading in relation to the reporting period;

(3) To my knowledge, the financial statements and other financial information in the Reports reflect fairly, from all material aspects, the financial condition, the results of operations and the cash flows of the corporation at the dates and for the periods to which the Reports relate;

(4) I disclosed to the auditor of the corporation, to the Board of Directors and the Audit and Financial Statements Committees of the corporation, based on my latest assessment of the internal auditing relating to the financial reporting and to disclosure:

(a) all the significant flaws and material weaknesses in the determination or operation of the internal audit on the financial reporting and disclosure that could reasonably have an adverse effect of the ability of the corporation to collect, process, summarize or report on financial information in a way that could cast doubt on the reliability of the financial reporting and preparation of the financial statements in accordance with the provisions of the law; and

(b) any deception, whether material or not material, in which the CEO or anyone directly subordinate to him is involved, or in which other employees are involved who fulfill important function in the internal audit of the financial reporting and disclosure;

(5) I, alone or together with others in the corporation –

(a) set controls and procedures or ascertained the setting and upholding of controls and procedures under my supervision, designed to ensure that material information relating to the corporation, including its consolidated companies as defined in the Securities (Annual financial statements) Regulations, 2010, is brought to my knowledge by others in the corporation and in the consolidated companies, particularly during the period of preparation of the Reports; and

(b) I set controls and procedures or ascertained the setting and upholding of controls and procedures under my supervision, designed to reasonably ensure the reliability of the financial reporting and the preparation of the financial statements in accordance with the provisions of the law, including in accordance with accepted accounting principles;

(c) I assessed the efficacy of the internal auditing of the financial reporting and discovery, and I presented in this report the conclusions of the Board of Directors and Management as to the efficacy of that internal auditing at the date of the Reports.

Nothing in the aforesaid derogates from my liability or the liability of any other person under the law.

March 7, 2011

Avraham Gabbay, CEO

Declaration of the most senior financial officer

I, Alan Gelman, declare that –

(1) I have reviewed the financial statements and other financial information included in the reports of Bezeq, The Israel Telecommunications Corp. Ltd. ("Bezeq") for 2010 ("the Reports");

(2) To my knowledge, the financial statements and other financial information in the Reports do not contain any incorrect representation of a material fact, nor is any representation of a material fact omitted which is needed to prevent the representations contained in them, in light of the circumstances in which they were included, from being misleading in relation to the reporting period;

(3) To my knowledge, the financial statements and other financial information in the Reports reflect fairly, from all material aspects, the financial condition, the results of operations and the cash flows of the corporation at the dates and for the periods to which the Reports relate;

(4) I disclosed to the auditor of the corporation, to the Board of Directors and the Audit and Financial Statements Committees of the corporation, based on my latest assessment of the internal auditing relating to the financial reporting and to disclosure:

(a) all the significant flaws and material weaknesses in the determination or operation of the internal audit on the financial reporting and disclosure insofar as it relates to the financial statements and to the other financial information in the Reports, that could reasonably have an adverse effect of the ability of the corporation to collect, process, summarize or report on financial information in a way that could cast doubt on the reliability of the financial reporting and preparation of the financial statements in accordance with the provisions of the law; and

(b) any deception, whether material or not material, in which the CEO or anyone directly subordinate to him is involved, or in which other employees are involved who fulfill important function in the internal audit of the financial reporting and disclosure;

(5) I, alone or together with others in the corporation –

(a) set controls and procedures or ascertained the setting and upholding of controls and procedures under my supervision, designed to ensure that material information relating to the corporation, including its consolidated companies as defined in the Securities (Annual financial statements) Regulations, 2010, insofar as is relevant to the financial statements and other financial information in the Reports, is brought to my knowledge by others in the corporation and in the consolidated companies, particularly during the period of preparation of the Reports; and

(b) I set controls and procedures or ascertained the setting and upholding of controls and procedures under my supervision, designed to reasonably ensure the reliability of the financial reporting and the preparation of the financial statements in accordance with the provisions of the law, including in accordance with accepted accounting principles;

(c) I assessed the efficacy of the internal auditing of the financial reporting and discovery, insofar as it relates to the financial statements and other financial information in the Reports at the date of he Reports; my conclusions as to those assessments were presented to the Board of Directors and Management and are integrated in this report.

Nothing in the aforesaid derogates from my liability or the liability of any other person under the law.

March 7, 2011

Alan Gelman, Deputy CEO and CFO

Annual report on the efficacy of internal auditing on financial reporting and disclosure pursuant to Article 9B(a)

Management, under the supervision of the Board of Directors of Bezeq, The Israel Telecommunications Corp. Ltd. ("Bezeq"), is responsible for setting and maintaining an appropriate internal control for the financial reporting and disclosure in the corporation.

For this matter, the members of Management are –

1. Avraham Gabbay, CEO
2. Alan Gelman, Deputy CEO and CFO
3. Ran Guron, VP marketing
4. Guy Hadass, Company Spokesman
5. Itamar Harel, VP Private Customers Division
6. Ehud Mezuman, VP Human Resources
7. Dudu Mizrachi, VP Economics Division
8. Adv. Amir Nachlieli, General Counsel
9. Yaakov Paz, VP Business Customers Division
10. Sharon Fleischer, VP Regulation
11. Eli Frank, VP Technologies Division
12. Yuval Kenan, VP Engineering and Network
13. Eyal Kamil, VP Operations and Logistics

Internal auditing of financial reporting and disclosure includes controls and procedures existing in the corporation, which were planned by the CEO and the most senior financial officer or under their supervision, or by whoever fulfills those functions in practice, under the supervision of the Board of Directors of the corporation, which were designed to provide a reasonable measure of assurance as to the reliability of the financial reporting and the preparation of the Reports in accordance with the provisions of the law, and to ensure that information that the corporation is required to disclose in the Reports it publishes in accordance with the provisions of the law is collected, processed, summarized and reported on the date and in the format laid down in law.

Internal auditing includes, among other things, controls and procedures planned to ensure that information that the corporation is required to disclose as aforesaid, is accumulated and forwarded to the Management of the corporation, including to the CEO and the most senior financial officer or to whoever fulfills those functions in practice, whoever fulfills those functions in practice, in order to enable decisions to be made at the appropriate time in relation to the disclosure requirement.

Due to its structural limitations, the internal auditing of financial reporting and disclosure is not intended to provide absolute assurance that misstatement in or omission of information from the Reports will be prevented or will be discovered.

Management, under the supervision of the Board of Directors, reviewed and assessed the efficacy of the internal auditing of the financial reporting and disclosure in the corporation; based on that assessment, the Board of Directors and Management of the corporation has concluded that the internal auditing of the financial reporting and disclosure in the corporation at December 31, 2010, is **effective**.