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

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

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

To Section 1.1.5 of the Periodic Report – Mergers and acquisitions

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

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

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

To Section 1.1.6 of the Periodic Report – Sales

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

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

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

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

To Section 1.4 – Distribution of Dividends

A. Further to Section 1.4.3 of the Periodic Report, on April 16, 2006, the Company paid its shareholders a cash dividend in a total amount of NIS 1,200,000,193, which constitutes, as at the date of the distribution, NIS 0.4606446 per share and 46.06446% of the issued and paid up capital of the Company.

B. On October 30, 2006, the Company distributed to its shareholders a further cash dividend in the total sum of NIS 400,000,064, which constitutes, as at the date of the distribution, NIS 0.1535482 per share and 15.35482% of the issued and paid up capital of the Company.

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

To Section 2.1 – General Information regarding the Area of Operations

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

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

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

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

To Section 2.2 – Products and Services

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

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

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

To Section 2.6 – Competition

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

To Section 2.6.1 of the Periodic Report – Telephony

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

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

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

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

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

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

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

D. On March 16, 2006, the Company applied to the Ministry of Communications to conduct a marketing trial of paid VOB (despite its clear position that it is entitled to supply that service under its license), receiving a reply in the negative.

E. In September 2006, a government resolution was passed on the matter of "increased competition in the field of telephony – virtual carriers and broadband access carriers", under which the Minister of Communications was required to review and formulate policy on the issue of provision of domestic telephony services by way of broadband access over the internet, no later than April 1, 2007. Likewise, it was resolved to require the Director General of the Ministry of Communications and the Commissioner for Budgets at the Ministry of Finance to jointly review the question of the operations of virtual carriers in the field of domestic telephony and to formulate, if necessary, a model for acting to encourage the operations of virtual carriers, by May 1, 2007. In this regard, see also Note 1(C)(5) of the periodic report of the Company for the period ending September 30, 2006.

F. Further to the provisions of section 2.6.1 of the periodic report regarding the policy for provision of VOD services – on October 25, 2006, the Ministry of Communications held a hearing for the relevant communications operators, in order to complete the process of formulating its policy in this area. According to the Ministry's press release, the hearing is to focus on the structure of the interconnect tariff to be paid to a VOB licensee for completion of a call on a "VOB network". According to the press release, the Ministry of Communications is considering a number of alternatives with regard to the issue under examination: (a) a mutuality arrangement under which the interconnect tariff for completion of a call on the network will be identical to payment of interconnection for completion of a call on the public telecommunications network of a domestic operator; (b) the interconnect tariff for completion of a call on a licensee's network will be dependent upon the proportion of the scope of traffic; (c) a combination of these two alternatives. The Ministry further gave notice that in addition, it would enable supplements to positions submitted in this respect in the past to be brought into the hearing, where necessary, including with regard to the issue of provision of VOB services by companies in the Bezeq Group.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

To Section 2.9 – Human Resources

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

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

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

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

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

To Section 2.13 - Financing

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

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

To Section 2.13.5 of the Periodic Report – Variable Interest Loans

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

To Section 2.13.6 of the Periodic Report – Credit Rating

1. Maalot rating – on April 4, 2006 the Company's existing rating (AA) for the debentures in circulation (private, public and Eurobonds), which had been on the Watch List since May 10, 2005, was ratified and validated, after renewed examination of the business risk, the financial risk and the Company's strategy, and following the sale of the Company's controlling interest to Ap.Sb.Ar. Holdings Ltd. (**"Ap.Sb.Ar."**).

2. Midroog rating – on April 11, 2006 the Company's rating was removed from the Watch List and left as Aa1. However, Midroog decided to lower the Company's outlook from stable to negative in order to reflect the possibility that the change in the Company's ownership will affect the Company's future business and financial profile.

To Section 2.15 – Environmental Protection

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

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

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

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

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

To Section 2.16 – Limitations and Regulation of Company Activity

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

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

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

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

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

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

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

To Section 2.16.3 of the Periodic Report – Royalties

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

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

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

To Section 2.16.7 of the Periodic Report – Antitrust Laws

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

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

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

To Section 2.16.9 – Proposed Legislation regarding Termination of Contractual Relations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

To Section 2.17 – Substantial Agreements

Management Agreement

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

To Section 2.18 – Legal Proceedings

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

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

To Section 3.2 – Products and Services

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

To Section 3.7 – Competition

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

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

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

In the matter of section 3.7.3 of the Periodic Report – on August 23, 2006, the Ministers of Communications and Finance gave notice that implementation of the plan would not be postponed beyond September 1, 2006. The Ministers' notice also stated that the Director General of the Ministry of Communications recommended that should the plan not be implemented and activated by such date, "the communications companies relevant to this issue shall be declared as being in infringement of the Law, with all that that entails". Following this resolution, Pelephone (together with other cellular companies) and Bezeq submitted petitions to the High Court of Justice for grant of a conditional order against the Government of Israel and the Ministry of Communications. In their petitions, the petitioners claim, *inter alia*, that even though they worked hard to implement the plan, and invested considerable resources in doing so, they are unable to comply with the unrealistic timetables prescribed in the Law for implementation of the plan. The petition further alleges that the Ministry of Communications has not prepared a numbering plan regarding number portability, and has not prescribed the structure for payments to be applied between the entities, as required under the provisions of the Law. At this stage, Pelephone is unable to assess the effect of the above. In the State's preliminary response to the petition, the State rejects the claims made in the petition, and holds the communications companies responsible for failure to comply with the regulating provisions of the statute. In this regard, see also update to Section 2.6.5 above.

To Section 3.15 – Financing

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

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

In the matter of section 3.18.1.1 –

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

breach of the provisions of the Communications Law. Under the approved proposal, a monetary sanction in the sum of approximately NIS 1.4 million (seven times the fine set out in section 61(a)(4) of the Penal Law) plus 0.25% of the licensee's total revenue during the financial year preceding the date of the breach will be imposed upon a licensee whose revenue during the financial year preceding the date of the breach is greater than NIS 100 million. This statutory amendment needs to be legislated in the Knesset.

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

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

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

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

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

In the matter of Section 3.18.3.1:

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

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

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

B. The Ministry of Communications is holding a hearing with regard to its intention to require a subscriber whose call is routed to a voicemail box be given the option of disconnecting the call with no charge, by means of a preliminary voice message notifying the subscriber that his call is being transferred to a voicemail box, and that he will be charged only from that time. In response to a hearing in writing, Pelephone expressed its objection to this process. If the Ministry of Communications puts its intention into full effect, this is expected to harm Pelephone's revenues.

C. In August 2006, the Ministry of Communications wrote to the cellular companies asking for their response to its intention to amend the companies' licenses with respect to severance of the link between a transaction for the purchase of cellular terminal equipment and the grant of benefits. Under the proposed amendment to the license, a licensee shall not create any connection between a transaction to purchase terminal equipment from cellular companies and the grant of a monetary benefit for consumption of airtime, or other benefits. In light of this, the Ministry of Communications is considering severing the link between the sale of terminal equipment by operators and the grant of benefits relating to cellular services. That is so as to ensure that subscribers of cellular companies who purchase terminal equipment from a different cellular operator or from equipment suppliers who are not cellular operators might receive the same conditions, including monetary credit for consumption of airtime, as they would have been entitled to had they purchased the terminal equipment from the cellular company of which they are subscribers. Pelephone has expressed its objection to this amendment to the license. At this stage, Pelephone is unable to assess the effect of this license amendment in the event that it is passed.

D. In August 2006, the Telecommunications (Royalties) Regulations 5761-2001 were amended so that as of January 1, 2006, the royalty rate is 3% of the revenue upon which royalties are charged. Each year, the royalty rate shall be reduced by 0.5% down to a rate of 1% from 2010 onwards. In this regard, see also update to section 2.16.3 above.

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

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

To Section 3.19 – Legal Proceedings

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

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

To Section 4.1 – General

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

To Section 4.1.2.2 – Royalties

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

To Section 4.6.1.1 – Competition in the field of voice

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

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

To Section 4.6.2.1 – Competition in the field of internet

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

To Section 4.9 – Intangible Assets

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

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

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

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

To Section 4.10 – Human Resources

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

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

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

To Section 4.14 – Investments

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

To Section 4.15 – Financing

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

To Section 4.19 – Legal proceedings

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

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

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

2. With respect to the claim by a competing international communications operator against the State of Israel for the sum of NIS 11.2 million dated April 4, 2004, under which the State of Israel filed a third party notice against the Company and Bezeq International, set out in section 4.19.2 of the Periodic Report for 2005, on December 5, 2005, the plaintiff submitted affidavits of evidence on its behalf. On April 9, 2006, the State submitted an expert opinion. On May 9, 2006, the Court ruled that given the lack of a factual version at this stage by the State, the Company's and Bezeq International's evidence regarding damage should be adduced on time, however, their evidence regarding liability should only be filed after hearing evidence from the State. On June 13, 2006, a preliminary hearing was held under which the Company and Bezeq International gave notice that they would not be filing an opinion as to damage. The plaintiff and the State also agreed in the hearing that the statement of claim, which another international carrier had filed against the State, the Company, and Bezeq International at the time, would be filed as evidence under agreement. The State also agreed to admit the fact that under the claim by the other international communications carrier, the parties applied to mediation, which ended in an agreement, together with payment by the defendant to the plaintiff. The matter has been set down for the hearing of evidence during the course of November 2006.

3. With respect to the claim submitted against Bezeq International and two other international operators claiming breach of patent for a prepaid telephone system in the sum of NIS 10 million by persons claiming to be the inventors and owners of the aforesaid patent, described in section 4.19.3 of the Periodic Report for 2005, on June 25, 2006, the plaintiffs submitted a response by them. In their response, the plaintiffs claim, *inter alia*, that their claim had not expired and was not tainted by laches, estoppel or injunction, that the patent was valid and belonged to them (and not to the State of Israel – Ministry of Communications), and they repeat their claims regarding breach of the patent by the defendants, and their demand to rule the relief sought under the statement of claim. On the same date, the plaintiffs also submitted an application to expunge claims from the statement of defense, regarding the claim that the plaintiff has no right of standing in this matter, and the claim that the general idea of the patent was conceived within the Ministry of Communications, during the period in which the plaintiff acted as Chief Scientist of the Ministry, and that therefore the plaintiffs are not the real owners of the patent. On September 20, 2006, the Court dismissed the application to expunge claims made in the statement of defense, and on October 4, 2006, the plaintiffs filed an appeal against that decision. On September 10, 2006, an amended statement of defense to the amended third party notice submitted by the defendants on July 30, 2006 was submitted by the supplier of the system the subject of the claim, of which Bezeq International had made use.

4. For additional updates regarding legal proceedings, see Note 7 to the Company's Financial Statements for the period ended September 30, 2006.

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

To Section 5.1 – General Information on Field of Activity

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

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

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

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

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

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

To Section 5.6 - Competition

To Section 5.6.5 – Principal Methods for Coping with Competition

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

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

To Section 5.10 – Raw Materials and Suppliers

To Section 5.10.1 – Main Raw Materials

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

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

To Section 5.11 – Working Capital

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

To Section 5.12 - Financing

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

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

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

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

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

To Section 5.14 – Restrictions and Supervision of the Corporation

To Section 5.14.1 – Specific legal regal restrictions on operations

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

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

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

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

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

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

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

To Section 5.17 – Legal Proceedings

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

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

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

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

In addition:

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

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

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

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

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

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

October 31, 2006

Date

"Bezeq", The Israel Telecommunication Corp. Ltd.

Name and title of signatories:

Dov Weissglas, Chairman of the Board

Yacov Gelbard, President & CEO