March 10, 2008

Bezeq The Israel Telecommunication Corp. Ltd.

Annual Report for 2007*

Chapter A: Description of Corporation's Operations

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

Chapter C: Financial Statements

Chapter D: Additional Details About the Corporation

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

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

Chapter A - Description of Company Operations

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

Chapter C – Financial Statements (Restated)

Chapter D – Additional Details About the Corporation

Chapter A – Description of Corporation's Operations

In this report, which contains a description of the Corporation's business operations as at December 31, 2007, the Corporation included forward-looking information, as defined in the Securities Law 5728-1968 (hereinafter: the "Securities Law") with respect to both itself and the market. Such information includes forecasts, targets, appraisals and assessments which apply to future events or matters the realization of which is not certain and is not under the Corporation's control. Forward-looking information in this report will usually be identified specifically, or by employing statements such as "the Company expects", "the Company assesses", "it is the Company's intention", and similar statements.

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

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

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

Since the financial statements of the Company for 2006, the Corporation has been reporting in accordance with international accounting standards (IFRS). The date of transition to IFRS was prescribed for January 1, 2005, and as a result, the Corporation has restated its financial statements for 2005 once again, these having been reported in the past in accordance with the accounting rules employed in Israel.

1. Description of General Development of Group Operations

1.1 Group Activity and Description of its Business Development

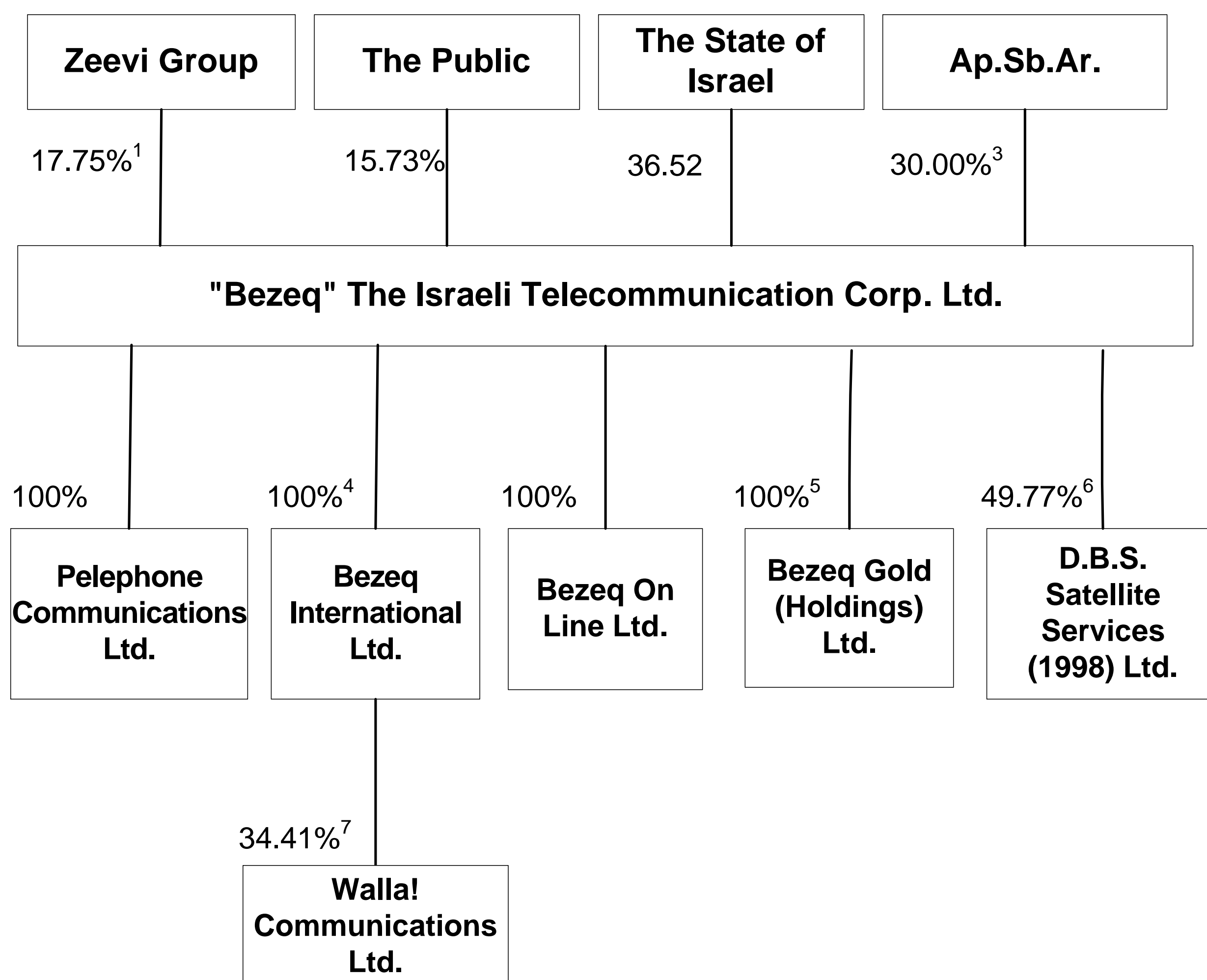
1.1.1 As of the date of this periodic report, The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international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

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

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

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

The following is a chart of the structure of shareholdings of the Company, and of the Company's shareholdings of its principle subsidiaries and affiliates, as at the date of publication of this period report:



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

[2] For the option granted to Ap. Sab. Ar. to purchase up to approximately 10.66% of the State's shares, see section 1.3 below; for the issue of options to employees for the State's shares in the Company, see section 2.9.6.1 below.

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

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

[5] A company whose only activity is to hold series 5 debentures of the Company (see section 2.13.7 and 2.17.1 below).

[6] As of the date of publication, the Company has option warrants which afford it the right to increase its holdings in DBS to approximately 58.36% (see section 1.1.5(a) below).

[7] 34.41% as at December 31, 2007 and 33.66% under full dilution. In addition, Walla! approved a plan to issue options to employees. Presuming full exercise of the options, the exercise shares shall constitute approximately 3.71% of the issued and paid-up share capital of Walla! and Bezeq International holdings in Walla! will be 32.41% under full dilution.

The Company's holdings are correct as at the date of publication of this periodic report. As set out in section 2.9.6 below, the State issued the Company with 122,697,648 options, exercisable for 122,697,648 shares of the Company held by the State. Under an employee option plan (apart from members of senior management), the Company allotted 78,151,368 options, convertible into 78,151,368 shares of the Company[8], and as part of an issue of options to managers and senior employees of the Group - 40,100,000 options convertible into 40,100,000 shares of the Company[9].

The following are details of the rates of holdings of the Company under full dilution, presuming exercise of all of the options issued as set out above, and presuming exercise of Ap. Sab. Ar.'s option to purchase approximately 10.66% of the State's shares in the Company as set out in section 1.3 below:

Shareholders	Percentage holdings as at March 26, 2008	Percentage holdings (fully diluted)
Ap. Sab. Ar.	30.00%	38.89%
State of Israel	15.73%	0.97%
Zeevi Group	17.75%	16.98%
The Public	36.52%	43.16%

1.1.5 Mergers and Acquisitions

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

On January 2, 2005, the Antitrust Commissioner conditionally approved the merger between the Company and DBS (increase of the Company's holdings in DBS to more than 50%). The merger did not take place within a year of the date of its approval, and required a new consent. On August 2, 2006, the Company and DBS submitted new merger notices to the Antitrust Commissioner (the "**Commissioner**") regarding the exercise of options for DBS's shares by the Company, which, if exercised, will increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Commission gave notice of the Antitrust Commissioner's objection to the merger and on February 18, 2007, the grounds for such objection were given. On May 15, 2007, the Company filed an appeal against the Antitrust Commissioner's decision to object to the merger with DBS. As at the date of publication of this periodic report, the appeal is before the Antitrust Tribunal. With respect to the Company's investment in DBS, see also Note 33 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

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

On February 11, 2007, proceedings were completed regarding merger of the operations of the subsidiary BezeCall Communications Ltd. (network end point operations) and the subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for business), so that the operations of BezeqCall were transferred to Bezeq International.

C. Acquisition of Tadiran-Telecom

In April 2007, an agreement signed by BezeqCall Communications Ltd. (prior to its merger with Bezeq International Ltd.) for the acquisition of all of the operations of Tadiran Telecom Communications Services Israel Limited Partnership was rescinded, in light of the decision of the Antitrust Authority not to approve the deal, and the partnership's subsequent notice of its decision to rescind the agreement.

1.1.6 Disposals

Satellite Communications Operations

The Company is acting to sell its satellite communications operations (Inmersat and BezeqSat).

[8] Of this amount, 59,574 options were allotted to two employee-directors.

[9] On March 10, 2008, the board of directors of the Company approved an issue of 5,600,000 additional options convertible into 5,600,000 shares of the Company to managers and senior employees of the Group. These options have not yet been issued.

1.2 Areas of Operation

The Group has four principal areas of operation. These four areas of activity are reported as business segments in the Company's consolidated financial statements (see also Note 28 to the Company's financial statements for the year ended December 31, 2007, included in this periodic report):

1.2.1 Fixed-line domestic communications

This segment primarily includes the activity performed by the Company as a domestic carrier, including telephony services, internet access services, transmission services and data communications.

1.2.2 Mobile Radio Telephone (MRT)

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

1.2.3 International communications, internet services and NEP

International communications services, internet access (ISP) services, and NEP services. These operations are done by Bezeq International Ltd. (hereinafter: "**Bezeq International**"). Bezeq International also holds 34.41% (33.66% fully diluted[10]) of Walla! Communications Ltd., an Israeli company whose shares are registered for trading on the Tel Aviv Stock Exchange, and which deals in the provision of services in the field of internet, and in the activation of internet portals (see section 4.14 below).

1.2.4 Multi-channel television

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

Note that in the past, the Company's financial statements contained a sector of operations headed "other" which included the operations of the companies BezeqCall Communications Ltd., which dealt with NEP services, the Goldnet Communications Services Partnership, which dealt with content services for the commercial sector, and Bezeq Online Ltd., which deals with call center services. Due to the merger of BezeqCall Communications' operations (see section 1.1.5 above) and Goldnet into Bezeq International, as of these financial statements, the "other" sector" in the financial statements of the Company mainly includes customer call center services (via the subsidiary Bezeq Online Ltd.), and investment in a venture capital fund. This sector is not substantial, at the Group level.

1.3 Investments in Equity and Stock Transactions

1.3.1 In 2005, the State of Israel completed proceedings for the sale of its control core of the Company to Ap. Sab. Ar. In this context, the State sold Ap. Sab. Ar., by way of private sale, 30% of the share capital of the Company (held in trust by Romema Investment Company Ltd.), and granted Ap. Sab. Ar. options to purchase an additional 10.66% of the share capital of the Company exercisable until the first business day falling at the end of 48 months after October 11, 2005 (the date of completion of acquisition of the Company's shares). As the Company has been informed, under the agreement between the State and Ap. Sab. Ar., Ap. Sab. Ar. shall be entitled to request that the State vote together with it (under the limitations set out in the agreement regarding certain matters) in respect of the 10.66% of the shares in the Company held by the State in respect of which Ap. Sab. Ar. has an option to purchase, and in respect of the 1.01% that will remain in the State's possession during the period commencing on October 11, 2005 (the date of completion of the transaction) and ending at the end of the option exercise period, and in respect of the 4.71% of the Company's shares held by the State and designated for allotment to employees of the Company (see section 2.9.6 below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

Note that Ap. Sab. Ar. has undertaken to the Company that during the period of four years following the date of execution of the new collective agreement of December 5, 2006 (see

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[10] See footnote 7 above.

sections 2.9.1 and 17.4(f) below), Ap. Sab. Ar. will not purchase shares in the Company as a result of which purchase Ap. Sab. Ar. shall have a holding of more than ninety percent of the share capital of the Company, and shall not respond to a full sale offer. This undertaking is noted in the collective agreement signed on December 5, 2006 (see section 2.9.1 below).

1.3.2 Employee Option Plans

As at the date of publication of this periodic plan, there are three plans for options for shares of the Company:

A. An employee option play of 2005, under which employees of the Company were offered up to 122,697,648 options for shares of the Company held by the State of Israel.

B. An employee option plan of 2007, under which the Company allotted 78,151,368 options for shares of the Company to its employees.

C. An option plan for managers and senior employees of the Group, of November 2007, for the allotment of up to 65,000,000 options for shares of the Company to senior managers and employees of the Company and of its affiliates (the general meeting's approval of issue of the options under this plan was given on January 31, 2008). Of this sum, as at the date of this periodic report, 40,100,000 options were allotted.

For further details regarding the above remuneration plans, see section 2.9.6 below.

1.4 Payment of dividends

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

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

1.4.3 Below are details of distributions made by the Company during 2006-2007 and up to the date of publication of this Periodic Report:

Date of distribution	Type of distribution	Total amount distributed (NIS millions)	Distributed amount per share (NIS)
16.4.2006	Cash dividend	1200	0.4606446
30.10.2006	Cash dividend	400	0.1535482
9.1.2007	Cash dividend	300	0.1151612
26.2.2007	Cash dividend[11]	1800	0.6909668
15.10.2007	Cash dividend	760	0.2917415

In addition, on March 10, 2008, the board of directors of the Company resolved to recommend that the general meeting of shareholders of the Company pay a cash dividend to the shareholders in the total sum of NIS 679 million (constituting NIS 0.260648 per share).

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

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

1.4.5 It is noted that under the agreement between the State and Ap.Sb.Ar. for the sale of the controlling interest in the Company, Ap.Sb.Ar. undertook, *inter alia*, to operate by virtue of its holdings and not to make a distribution which was not from the accumulated retained earnings of the Company on December 31, 2000 (it was clarified that this would not prevent the distribution of earnings generated after December 31, 2000 in accordance with

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

the Companies Law, 5759-1999). Ap.Sb.Ar. also undertook to operate by virtue of its holdings so that a distribution would not be made from the capital gains deriving from the realization of capital assets paid for in kind, for a period of two years from the date of purchase of the shares being sold (this period ended on October 10, 2007).

1.5 Financial Information regarding Areas of Group's Operations

1.5.1 2007:

	Domestic fixed-line communication	Cellular	International communications, internet services and NEP	Multi-channel television	Other	Adjustments to consolidated*	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Total Revenues:							
From externals	5,373	4,380	1,226	1,402	19		12,400
From other areas of corporation's operations	340	304	78	12	46	(780)	
Total	5,713	4,684	1,304	1,414	65	(780)	12,400
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,102	3,712	961	1,225	64		10,064
Costs constituting revenues from other areas of operation	332	168	140	139	1	(780)	
Total	4,434	3,880	1,101	1,364	65	(780)	10,064
Operating profit	1,279	804	203	50	-		2,336
Total identified assets as at December 31, 2007	7,769	4,290	628	1,097	59	229	14,072
Minority percentage in the segment					17.5%		

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

1.5.2 2006:

	Domestic fixed-line communication	Cellular	International communications, internet services and NEP	Multi-channel television	Other	Adjustments to consolidated*	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Total Revenues:							
From externals	5,514	4,141	1,219	1,339	19		12,232
From other areas of corporation's operations	285	337	82	23	37	(764)	
Total	5,799	4,478	1,301	1,362	56	(764)	12,232
Total attributed costs:							
Costs not constituting revenues in another area of operation	4,689	3,625	1,090	1,209	54		10,667
Costs constituting revenues from other areas of operation	364	161	92	145	2	(764)	
Total	5,053	3,786	1,182	1,354	56	(764)	10,667
Operating profit	746	692	119	8			1,565
Total identified assets as at December 31, 2006	9,837	3,717	631	1,008	47	214	15,454
Minority percentage in the segment							

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

1.5.3 Principal results and operational data

A. Bezeq Fixed-Line (the Company's activity as domestic carrier) (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	5,713	5,799	5,893	1,453	1,425	1,393	1,442	1,439	1,465	1,440	1,455
Operating profit	1,279	754	919	340	327	243	369	(197)	363	280	308
Depreciation and amortization	941	1,026	1,109	233	236	235	237	251	259	258	258
Investments in plant & equipment and intangibles	504	578		141	149	101	113				
Proceeds of sale of plant & equipment	153	39		23	16	96	18				
Number of active subscriber lines as at the end of the period (thousands)	2,761	2,808	2,848	2,761	2,767	2,778	2,797	2,808	2,813	2,822	2,831
Average monthly revenue per line (NIS)*	84.2	87.0	87.8	83.3	83.6	83.2	86.4	86.2	88.0	86.6	87.3
No. of outgoing usage minutes (millions)	15,254	16,786	18,448	3,738	3,849	3,753	3,914	4,005	4,257	4,202	4,322
No. of incoming usage minutes (millions)	4,426**	3,715	3,051	1,164	1,149	1,069	1,045	990	967	890	868
Number of ADSL subscribers as at the end of the period (thousands)	963	892	800	963	942	924	912	892	867	844	827
Average monthly revenue per ADSL subscriber (NIS)	58.0	57.0	58.6	58.1	58.5	58.1	57.4	57.0	56.6	56.8	57.7

* Not including revenues from transmission and data communications services, services to communications carriers, contract work and other.

** Most of the increase in incoming minutes flows from an increase in traffic minutes from domestic fixed-line communications providers in competition with Bezeq.

B. Pelephone (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	4,684	4,478	4,428	1,182	1,203	1,152	1,147	1,148	1,144	1,097	1,089
Operating Profit	805	701	591	133	219	240	213	157	171	198	175
Depreciation and amortization	478	470	438	125	121	115	117	114	116	120	120
EBITDA	1,283	1,171	1,021	258	340	355	330	271	287	318	295
Net profit	585	486	287	104	154	173	154	125	111	124	126
Cash flow from current operations	1,249	1,324	974	252	392	246	359	294	337	408	285
Investments in plant & equipment and intangibles	381	354	556	120	81	117	63	106	65	84	99
Proceeds of sale of plant & equipment	5	8	4	3	-	-	2	4	1	2	1
Number of subscribers at end of period (in thousands)	2,622	2,427	2,287	2,622	2,560	2,513	2,478	2,427	2,366	2,323	2,306
Average use minutes per subscriber per month (MOU)	354	349	338	358	363	350	344	347	357	346	345
Average monthly revenue per subscriber (NIS) (ARPU)	131	138	138	130	135	129	132	136	142	141	136
Number of 3G subscribers at end of period (in thousands)	749	255	60	749	607	471	358	255	146	115	85
% revenues from value added services and content, of revenues from cellular services	12.7%	10.7%	8.6%	13.6%	12.8%	12.5%	12.0%	11.6%	10.9%	10.3%	10.0%

C. Bezeq International (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	1,304	1,021	815	333	326	322	323	265	259	255	242
Operating profit	204	132	93	45	54	54	51	25	36	38	33
Depreciation and amortization	87	81	91	21	21	22	23	26	19	16	20
Net profit	153	96	104	38	39	39	37	20	29	29	18
Cash flow from current operations	95	209	188	30	34	32	(1)	72	55	32	50
Investments in plant & equipment and intangibles*	91	55	63	36	29	18	8	14	14	14	13
Proceeds of sale of plant & equipment	4	-	2	2	2	-	-	-	-	-	-

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

D. DBS (NIS millions except where stated)

	2007	2006	2005	Q4 2007	Q3 2007	Q2 2007	Q1 2007	Q4 2006	Q3 2006	Q2 2006	Q1 2006
Revenues	1,415	1,355	1,222	347	360	354	354	345	340	338	332
Operating profit	56	1	(64)	5	(4)	31	24	10	(11)	7	(5)
Depreciation and amortization	273	293	285	70	66	69	68	72	74	74	73
Net profit (loss)	(118)	(320)	(346)	(75)	70	(65)	(48)	(42)	(97)	(97)	(84)
Cash flow from current operations	250	244	137	76	56	25	93	96	27	75	46
Investments in plant & equipment and intangibles*	255	186	259	81	84	45	45	38	39	55	54
Proceeds of sale of plant & equipment	-	-	1	-	-	-	-	-	-	-	-
Number of subscribers as at the end of the period (thousands)	549	540	521	549	545	543	542	540	539	535	528
Average monthly revenue per subscriber (NIS)	217	212	205	212	220	218	218	214	211	212	211

* This item also includes investments in the cost of acquiring subscribers.

Note to all of section 1.5.3: Note that non-substantial adjustments have been effected with respect to some of the data in previous quarters as a result of measurement changes and credits.

1.6 Forecast for Group

Based on current commercial conditions, the assessment is that in 2008, the level of the Group's revenues shall remain stable and shall express an ongoing erosion of fixed-line telephony, together with an increase in the other areas of operation. Furthermore, progress is expected in reduction of costs and increase of profit margins. With respect to the Group's investments in plant and equipment, the assessment is that an increase of approximately 50% is expected, mainly as a result of the investment by Pelephone in the next generation of network infrastructure (HSPA).

The information in this section includes forward-looking information, based on the Company's assessments. Actual results might be substantially different from the above assessments, taking into account the changes that might occur to commercial conditions, and the impact that regulatory decisions might have.

1.7 General Environment and Effect of External Factors on Group Activity

The Group's business is affected by the level of the financial activity in the domestic market and therefore, positive or negative developments at this level are expected to have a corresponding impact on the business of the Group.

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

2. Fixed-Line Domestic Communications –

"Bezeq" – The Israel Telecommunications Corp. Limited ("the Company")

2.1 General Information on Area of Operations

2.1.1 Area of activity and changes affecting it

The Company has a general license for the provision of fixed-line domestic communications services. In this context, the Company provides telephony services; broadband internet access services (ADSL); household networks and dial-up internet service provider access; transmission services; information and data communications services; IP-VPN services; remote access services; maintenance and development of infrastructure; other operations including set-up and operation of broadcast facilities for radio and television transmissions, laying and maintenance of television cables, satellite and video services, sale of terminal equipment, billing and collection services and other services to other communications providers; IP services; Centrex; access services between users and internet service connection providers (ISPs); the rate of development of the communications industry around the world and in the Israeli economy is very fast. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

2.1.2 Legislative and regulatory restrictions and special constraints

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

The tariffs for the Company's main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, *inter alia*, according to recommendations of the Committee for the Regulation of Bezeq's Tariffs. The tariffs were recently amended on June 1, 2007. The Company's interconnect tariffs were reduced as of June 1, 2007 (see section 2.16.1).

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

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

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

See section 1.5.3(a) above.

2.1.4 Developments in the market and in customer attributes

In recent years we have seen growing competition between fixed-line and cellular telephony. If in the past almost all calls were made between two fixed lines, today, in the Company's assessment, more than 60% of calls are made over the cellular networks. As the number of cellular subscribers has grown and reached approximately 9 million subscribers (according to data published by the cellular companies), there has been a decline in the number of households and businesses holding a fixed line, as well as a decline in the number of lines per customer. Furthermore, there has been an ongoing average decline in the Company's regulated and unregulated tariffs (see Section 2.16.1 below). On the development of competition in the domestic fixed-line communications area, see section 2.6 below.

2.1.5 Technological changes that significantly impact on the area of operations

A. Penetration of high speed internet and the availability of new IP-based technologies offer consumers a wide variety of applications and services over IP-based infrastructures, such as voice services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

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

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

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

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

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

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

A. Regulatory decisions

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

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

D. Technological and marketing innovation.

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

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

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

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

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

2.1.7 Main entry and exit barriers of the activity and changes affecting such

The main entry barrier in the domestic fixed-line communications market is attributable to the need for substantial investments in technological infrastructure and complementary systems until economies of scale are achieved, and from the high costs involved in establishing marketing, sales and customer support systems and the construction of brands. In recent years the traditional entry barriers to the Company's areas of activity have been to a great extent removed, as a result of the following factors: Technological improvements, reduction of infrastructure and equipment prices; the regulatory relief given to new competitors, and the ability to exploit existing systems, including the Company's network (inter alia due to regulatory decisions) by competing communications carriers or carriers intending to compete with the Company.

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

2.1.8 Alternatives to and changes in products of area of operations

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

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

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

2.1.9 Structure of competition in the areas of operation and changes therein

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

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

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

In the field of telephony, Hot Telecom, a partnership of the cable companies the merger of reach was recently concluded (hereinabove and hereinafter: "Hot" or "Hot Telecom") to provide services on a commercial basis on November 25, 2004.

A number of companies were also given special general licenses for the provision of domestic fixed-line communications services, without an obligation provide services to everyone. On January 31, 2007, a policy was published regarding the provision of telephony services over broadband access services (by the Company and by HOT). With regard to this matter, see Section 2.6.1 below. Additionally, the Company views cellular

telephony services as alternative services to the telephony services it provides. With regard to this matter, see Section 2.6.4 below.

Competition in the sector is dependent on a variety of factors, including: Development of competition with Hot and 012 Telecom Ltd., provision of licenses to other domestic providers, increased competition with cellular companies; possible changes to conditions of the licenses of the Company and the subsidiaries, and conditions of the licenses of their competitors; mergers and joint ventures between companies in competition with companies in the Group; financing universal service; the new services that the Company is permitted to offer; tariff policy and the level of flexibility available to the Company in offering service packages, including with subsidiaries, and in the recommendations that the Grunau Commission will formulate in the field of communications in Israel, and the manner of adoption and implementation thereof (see section 2.6 below).

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

2.2 Products and Services

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

2.2.2 Telephony

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

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

The Company currently operates approximately 12,000 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. Since phone cards are no longer available for purchase, the Company is working towards finding a substitute that will enable it to continue providing the service. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, but the draft was not approved by the Knesset Economics Committee, which resolved that the Ministry of Communications should submit a revised draft. As at the date of publication of this periodic report, the Company is not aware as to whether an amended bill has been submitted by the Ministry of Communications, however to the best of its knowledge, the Ministry of Communications intends to start working anew in this regard.

On February 8, 2006, the Company license was amended so that, *inter alia*, commencing February 8, 2007, the Company is required to provide, itself or through another entity acting on its behalf, a telephone number information service of whoever is a subscriber of a fixed-line or cellular operator, excluding unlisted numbers, for the general public and without payment via the internet and for its subscribers at a reasonable price through a service center. Since February 8, 2007, the Company has operated a unified service center, by a network code set by the Ministry of Communications (1344), including for the cellular operators and for HOT. This is additional to the Company's 144 service.

On October 15, 2007, the Company filed an application to the Antitrust Authority to exempt it from obtaining approval of an agreement in restraint of trade for the arrangement between the Company and the cellular carriers and domestic fixed-line licensees to operate the information service (144), the unified information service for telephone numbers of the Company and other carriers (1344) and the unified website that provides corresponding services. The application was filed for the sake of caution and in light of a letter from the Antitrust Authority dated September 9, 2007, giving notice that the Antitrust Authority viewed the agreement the subject of the application to be an agreement in restraint of trade.

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

As part of the Company's marketing strategy, it is acting to develop and introduce new services in both the private and business sectors. The Company intends to continue launching additional products, in accordance with market trends and customer needs.

2.2.3 <u>Internet access services</u>

These services enable access to the internet and are in principle high speed internet access services using ADSL technology.

At the end of 2007, the Company had approximately 963,000 ADSL subscribers (compared with approximately 891,000 subscribers at the end of 2006), amounting to approximately 61% of the broadband internet market in Israel (based on items in the Israeli media regarding the number of subscribers who are not subscribers of the Company). For changes in the number of the Company's ADSL subscribers and average monthly revenue per ADSL subscriber, see section 1.5.3(a) above.

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

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

On March 5, 2008, the Company received a letter from the Director General of the Ministry of Communications stating that the Ministry had decided, following examination of the Company's position, to amend the Company's service portfolio regarding "high-speed access service via ISP", so as to enable broadband access to internet service providers (ADSL) without such supply being conditional upon the purchase of a basic telephone subscription ("ADSL only"). The Ministry accepted the Company's position that it be allowed to continue to offer a combined ADSL and telephone subscriber line in the existing format ("ADSL combined") alongside the ADSL only service. Payment for the ADSL only service will be prescribed by the Company, in accordance with section 17 of the Communications Law (which applies to those of the Company's services which are not under tariff supervision). According to the Ministry's resolution, the amended service portfolio will come into force on May 15, 2008. The above decision by the Ministry might have an adverse effect on the Company and on its tariff structure, and this cannot be assessed at this stage.

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

Data communications services are network services for the point-to-point transfer of data over the Company's infrastructures, transfer of data between computers and various communications networks, services to connect communications networks to the internet and remote access services.

Data communications services are provided over established traditional infrastructures such as digital and frame relay lines, as well as over innovative and advanced infrastructures including ATM and IPVPN (Virtual Private Network). The IPVPN infrastructure enables managed communications solutions for businesses by connecting the various branches of the organization. In recent years customers have been switching from data communications solutions provided over older traditional infrastructures to IP-based infrastructures.

The Company offers transmission services, including high speed services, to its business customers and communications carriers over a variety of protocols (see section 2.6.3 below).

2.2.5 <u>Other services</u>

A. Services to Communications Carriers

The Company provides services to other communications carriers including the following: cellular operators; international operators; cable broadcasting licenses; the Israel Broadcasting Authority and The Second Authority for Television and Radio; network endpoint operators; ISPs; domestic operators; Palestinian communications providers.

Among the services provided by the Company are infrastructure services, connection to the Company's network, transmission services, billing and collection services, *inter alia* to international carriers, rental of space and provision of services at rented space, and provision of rights to use underwater cables.

B. Satellite and broadcasting services

The Company provides satellite services via fixed antennas (in the Ella Valley and the Ramla area), mainly including services for international communications: video transmission services and satellite relay broadcasts for foreign broadcasting organizations in Europe and Asia. The Company also operates mobile units for television broadcasts via satellite from time to time.

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

The Company operates and maintains radio networks operated, inter alia, by the Israel Broadcasting Authority, Channel 1's television transmitters and those of Educational Television, Channel 2's television transmitters and the transmitters of regional radio stations. The Company is only responsible for operation and maintenance of the transmitters in order to distribute broadcasts of radio and television programs, and not for the content of the broadcasts. In this regard, see also section 2.15.1 below.

C. Contract work

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

There are agreements for the provision of installation and maintenance services of cable networks for cable television between the Company and two cable television broadcast licensees which were recently merged using the Company's infrastructure, from the starting point of the above licensees' operating point up to the point of delivery at the entrance to subscriber homes (the connection and maintenance from these points up to the subscribers' homes is not within the Company's responsibility). Note that the merged company, Hot Telecom, has taken upon itself all rights and obligations under these agreements.

D. IP Centrex

The IP Centrex service is a virtual private exchange service. Pursuant to a letter from the Ministry of Communications, the Company has submitted a service portfolio to the Ministry of Communications with respect to this service, which is provided by it.

E. Data Center

At the beginning of 2008, the Company launched its Data Center project, which enables provision of a total solution for customers, including in aspects of back up and survivability of services. The service that is planned follows a large increase in customer demands for DRP sites (disaster recovery program – a program for continuing work in the event of a disaster), and for real back-up of information at all organization levels. The Data Center site is expected to provide the Company's customers with a variety of solutions, including: hosting the organization's central site, taking into account

requirements of survivability, electricity, airconditioning, etc., back-up of the organization's information on a reliable and protected system so that if necessary, it will be possible to restore the required information, remote back-up of organization information, full DRP for the organization's central site, and storage of the organization's important information at a protected underground site.

2.3 Breakdown of Revenues and Profitability of Products and Services

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

	2007		2006*	
	NIS millions	**% of revenues**	**NIS millions**	**% of revenues**
Telephony	3,905	68	4,148	72
Internet	712	13	608	10
Transmission and data communications	754	13	711	12
Other services	342	6	332	6
Total	5,713	100	5,799	100

* reclassified.

2.4 Customers

2.4.1 The Company is not dependent on any single customer or on a limited number of customers, which if lost would significantly impact on the area of activity.

2.4.2 The Company does not have any single customer generating revenues of 10% or more of its total revenues.

2.4.3 Company sales are divided into two main sectors: the private sector (approximately 61%) and the business sector (approximately 39%). This division is based on revenues.

2.5 Marketing, Distribution and Service

2.5.1 The Company has marketing, sales and service systems for the private and business sectors, which include customer managers for the business sector, joint sales and service centers (including the 199 center) located throughout the country, separate technical support centers for internet and IT services, support and repair centers for telephone services (166 center), as well as 17 points of sale and service (the Bezeq Store network) around the country.

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

2.6 Competition

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

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

In December 2006, the Minister of Communications appointed a public commission, headed by Professor Grunau, to formulate detailed recommendations concerning the policy and principles of competition in communications in Israel. The amended letter of appointment of the Commission, dated February 2007, stated that the Commission is requested to formulate its recommendations, *inter alia*, on the following important issues: The question of the need for separation between the various sectors of operations (transmission / content), the issue of the operations of consolidated 'communications groups' and the rules of structural separation that apply to the Bezeq Group and others; the marketing of service packages and the flexibility of tariffs for Bezeq; the access of competitors to the infrastructure of licensees (Bezeq, the cable companies and others) whilst

examining various models such as unbundling, convergence between mobile and fixed line communications and voice, video and data services. In addition, provision of broadcasts on communications operator platforms such as ADSL, cable, mobile, WIMAX, either under the IPTV method or using other methods; the scope of the universal service obligations imposed upon communications carriers. Likewise, the letter of appointment further provides that the Commission shall be permitted to extend the list of issues, should it find that such are essential for the formulation of its recommendations.

At the beginning of January 2007, the public was invited to present positions on the subject and to comment on the above. The Commission started its work in February 2007. As at the date of publication of this periodic report, it is expected, to the best of the Company's knowledge, that the Commission will submit its recommendations during the course of March 2008.

The Company's initial position was presented in a document filed with the Commission on April 11, 2007. Note that the Company's positions are developing and changing with time.

The Commission's recommendations, which require the consent of the Minister of Communications, are supposed to relate to those issues that are most substantial to the communications market and the Company, and might generate changes in the rules of competition in place to date. The Company estimates that these recommendations, if approved, might have a substantial adverse affect on the Company, however, it is unable now to assess the trends or consequences that might flow from these.

2.6.1 <u>Telephony</u>

Competition with HOT, which received a general license for the provision of domestic fixed-line services including telephony, is increasing, and is expressed, *inter alia*, in offers by HOT which combine broad band internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers. Pursuant to HOT's reports, its telephony service covers approximately 288,000 cable telephone subscribers, as at the end of Q3, 2007.

The Company petitioned the High Court of Justice against the Minister of Communications, in an application for immediate enforcement on HOT of its obligations and commitments under its license, concerning structural separation.

On November 8, 2007, the Company filed an application with the High Court of Justice to amend the petition so as to include the Company's reservations against amendment of HOT's license enabling it to market a basket of services including HOT Telecom services and broadcast services provided by HOT's broadcast company.

On December 2, 2007, implementation of the number portability program commenced. Number portability increased the level of competition in the domestic field, and with HOT in particular. In this regard, see also section 2.6.6A below.

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

<u>VOB[12]Service Policy</u>

Pursuant to a policy paper published by the Ministry of Communications on January 31, 2007, the Company and its subsidiaries shall be entitled to supply VOB services only after the Company's market share in the field of domestic fixed-line telephony in any particular customer sector (business or private) falls below 85% (with respect to calculation of market share, see section 2.16.2 below). With respect to DBS, the test point will be set one year

[12] Voice Over Broadband

after the effective date (February 1, 2007), when the possibility of granting it a VOB license will be examined to see if its competitive status has deteriorated, and noting the situation of the competition in fixed-line domestic telephony.

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

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

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

Implementation of these provisions substantially harms the Company and its subsidiaries, and their ability to compete. Implementation of ADSL only (see section 2.2.3 above) will increase the attractiveness of the competitors' VOB services.

For the positions of the subsidiaries Pelephone, Bezeq International and DBS in this regard, see (respectively) sections 3.7.4, 4.1.5 and 5.6.5(h) below.

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

2.6.2 Broadband internet access

In the field of broadband internet access, competition has been keen since the cable partnerships (now HOT) began competing with the Company in this area in March 2000. On March 5, 2008, the Ministry's decision was handed down regarding requiring the Company to provide broadband access to internet service providers without a telephone line. (See also section 2.2.3 above).

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

According to reports by HOT, it currently serves more than 590,000 high-speed cable internet customers.

2.6.3 Transmission and data communications

The companies that operate in this area are Cellcom, Partner, HOT, and the internet companies that also make use of leased infrastructure.

Cellcom has set up an independent backbone to connect its switches, which it uses for both its own purposes (instead of transmission which in the past was provided by the Company) and for competition against the Company in the transmission and data communications market.

On August 15, 2006, Partner was granted a special license for providing transmission and data communication services, after purchasing the operations of Med-1. Purchase of the

operations of Med-1 as aforesaid shall cause harm to the Company's revenues from the transmission services that it provides to Partner.

2.6.4 Competition from the cellular companies

The penetration rates of cellular technology in Israel are among the highest in the western world. The Company's opinion, which is not accepted by the Ministry of Communications or the Antitrust Commissioner, is that the penetration rate, combined with airtime tariffs which are low in international terms, have made cellular phones a product which is largely interchangeable with telephone lines. Over the past two years, there has been steady erosion, albeit at varying rates, in the number of voice minutes over the Company's network, as a result of a slow-down in the pace of growth of the cellular companies. There has also been an increase rise in calls from the networks of fixed-line domestic operators to the cellular networks. The Company believes that increasing interchangeability between fixed-line and cellular telephones is one of the reasons for the growing rate at which telephone lines are being removed, to the extent that approximately 15% of Israeli households today do not have a fixed line (compared to approximately 5% in 1996).

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

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

2.6.5 VOD[13]Service Policy

On March 15, 2007, the Ministry of Communications published the final policy paper on the issue of licensing and regulation of on-demand broadcast services (VOD) under which the Communications Law would be amended so as to permit the award of new licenses for these services; likewise, according to the document, DBS is to be permitted to supply VOD services over the Company's ADSL, under restrictions that shall apply with respect to the Company's infrastructure: the Company will be required to allow a VOD licensee and DBS to use the ADSL infrastructure for providing VOD services on equal terms; the Company will be given usage instructions according to Section 5 of the Communications Law; and payment will be equal and transparent, and will include the cost deriving from connection of the service provider to the network.

In July 2007, an amendment of the Communications Law was passed entitling additional content providers other than HOT to provide the service of supplying content upon subscriber demand over a broadband managed access network, using IP technology. The significance of this amendment, according to the restrictions set out in it is, *inter alia*, that the Company's subsidiaries (apart from DBS) will not be allowed to supply that service.

In this regard, see also sections 5.4 and 5.6.5 below.

2.6.6 Additional factors that may affect competition

A. Numbering and number portability

On December 2, 2007, the number portability program began to be implemented, enabling a transfer of customers between the various communications carriers without changing their telephone numbers, and the petitions to the High Court of Justice filed by the cellular companies and by the Company were withdrawn by the consent of all of the parties, whilst reserving their rights.

Number portability increases competition and the strength of such competition, as well as customer awareness of the market, and gives rise to a significant increase in the number of calls made to the Company's service centers.

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[13] Video On Demand services.

As at the end of February 2008, approximately 55,000 lines were ported away from the Company, the majority transferring to HOT. Number portability increased the churn rate of the Company's telephone and internet lines by approximately 4% calculated annually. The increase in the churn rate is expressed mainly in the private sector, and in lower percentages in the business sector. In the Company's assessment, the increased churn rate is likely to continue, due to increased activity by the competitors, and due to the matter's being on the agenda.

Note that on May 24, 2007, the Company received a notice from the Director General of the Ministry of Communications stating that he was considering imposing financial sanctions on the Company under Chapter G1 of the Communications Law, 5742-1982, due to alleged breach of the duty to provide number portability as of September 1, 2006. The Company, Pelephone and Bezeq International responded to the notices of the Ministry of Communications.

B. Other potential competing infrastructures

In addition to the HOT's cable and fiber-optic network and Cellcom and Partner's fiber-optic infrastructures, there are a number of fiber-optic networks in Israel today, most of which are owned by State-owned companies or government agencies. These include Israel Electric Corporation, Israel Railways, Mekorot, the Oil Infrastructure Company and the Cross-Israel Highway Company. At this stage, there is no use of the aforesaid infrastructure in competition with the Company. Some municipalities are also attempting to create an alternative to the laying of pipelines by communications licenses, via the infrastructure held by such municipalities.

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

On September 24, 2007, the Ministry of Communications published a hearing regarding the policy for allocating frequencies to broadband wireless access networks. According to the Ministry of Communications document, the Minister of Communications intends to publish a policy for allocation of frequencies for a broadband wireless access network (WiMAX) as set out in the draft policy attached to the document. The Company filed its response to the Ministry of Communications on November 19, 2007 to the effect that preference in allocation should be granted to Bezeq due to the universal service obligation by which it is bound, as well as its ability to provide an immediate and continual service over the required frequencies.

C. Advantages and technological developments

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

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

Another competitive factor is the “Bezeq-bypass networks”. There are two main types of bypass networks: (1) those built on the Company’s infrastructure – mainly PTP lines of various kinds and internet infrastructure; (2) those which use other infrastructure, or redirect traffic to them, mainly various kinds of wireless-cellular networks, microwaves, laser, satellite, and cellular adapters. Systems using a combination of both of these types also exist.

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

2.6.7 The Company's preparations for and methods of coping with increasing competition

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

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

B. The Company took action to introduce broadband (high-speed) internet services using ADSL technology and is working to increase the number of customers it has in this area. The Company provides an “IPVPN secured business access service”, which provides secure connectivity of branches and enables employees to connect from their homes to their organization’s network. It also launched an ADSL-based service for business customers and high-speed data communications services for business customers and communications providers.

C. The Company is always working to improve the quality of its services and to retain its customers.

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

E. The Company will implement a new billing system for business and private customers.

F. The Company is working to heighten awareness of use of the fixed-line telephone and to promote the use of other services which increase telephone use, such as numbering services (1-800), voice mail, marketing of digital cordless phones, telephone information services and other value-added services.

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

H. After execution of the new collective agreement, the Company is acting in order to implement and assimilate the new organizational structure of the Company (see section 2.9.1 below).

I. The Company is looking into the method in which it will integrate into the process faced by other communications companies around the world, regarding the deployment of uniform infrastructure for transmission of voice communications services, high-speed internet services and content, leisure and entertainment applications. The Company’s resolutions in this regard will be passed, inter alia, subject to regulatory policy.

J. During the course of December 2007, the Company launched a new logo and slogan. Part of this process included connecting the Company to the home using the phrase "Bezeq – the best at home". This included media advertising, billboards and branding of the Company's assets.

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

Positive factors

A. National deployment of infrastructure via which a variety of services are provided.

B. Presence in most businesses and households.

C. Strong capital structure and positive cash flow.

D. Expansive service infrastructure and various customer interfaces.

E. Professional, experienced and trained staff.

F. Strong, well-known brand.

Negative factors

Regulation

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

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

The Company has been prohibited from offering packages of services jointly with companies in the Bezeq Group, though these types of packages are offered by its competitors. The absence of such an option is a major disadvantage in the Company's ability to compete.

B. Lack of tariff flexibility

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

C. Obligation of structural separation

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

D. Universal service obligation

The Company is under an obligation to provide services to the entire public in Israel (universal service), and as a rule, the Company is in compliance with this obligation. This obligation is not imposed on the special local carrier licensees, which can offer their services to the Company's profit-bearing customers (particularly business customers), which represent a significant source of revenues for the Company.

The Company believes that a fund should be established to finance this universal service, so that a carrier that does not provide service to any party requesting it will pay into the fund through which the universal service will be funded.

E. Accessibility Deficit

The Company's telephony tariffs are prescribed in regulations made by the Minister of Communications with the consent of the Minister of Finance. As a result of intentional regulatory policy, the monthly usage tariff for a telephone line is set at a level that does not cover the costs involved in providing the line (a situation known as an 'accessibility deficit'). This deficit has been reduced over the years, inter alia as a

result of the activities of the various tariff committees, however it still exists. Note that given that competition relies on the Company's infrastructure and (such as VOB services) exploits the accessibility deficit, the negative impact of this factor is increasing. As noted in the preamble to this section 2.6, in December 2006, the Grunau Commission was set up to formulate recommendations regarding policy and rules of competition in the field of communications in Israel, which is to recommend changes in the above.

Labor relations

Labor relations in the Company make flexibility of its operations and its ability to deal with competition more difficult (see also section 2.21(d) below).

Competition

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

2.7 Property, Plant & Equipment

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

2.7.2 **Fixed-line domestic telecommunications infrastructure**

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

A. Exchanges

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

B. Transmission network

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

C. Data communications networks

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

D. Access network

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

E. Terminal Equipment

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

2.7.3 **Computing**

The Company's IT system supports four central areas:

A. Marketing and customer management

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

B. Information systems for engineering infrastructures of the telecommunications networks

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

C. Information systems for management of Company resources

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

D. Cross-organization systems

Support decision-making processes via a data warehouse system (DWH) operated by the Company. Likewise, the Company operates a website which provides information on the Company's services and enables presentation of information regarding telephone bills, payment of telephone bills and other services. The Company also operates computerized office systems (email, resolution follow-ups, etc.), knowledge management systems, etc.

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

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

2.7.4 **Real Estate**

A. General

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

As at the date of publication of this periodic report, the Company has freehold or leasehold title or the right to lease approximately 425 real estate assets around the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights as set out below), amounts to approximately 1,345,000 m^2 of land, of which approximately 365,000 m^2 is built up. Six of these properties are in Israeli settlements in Judea and Samaria, approximately 7,000 m^2 in area, with a total of approximately 500 m^2 being built up.

In addition, the Company has a right to land of approximately 70,000 m^2 in area at Sakia (near Messubim Junction), for the purposes of storage and offices. Recently, a draft contract permitting the Company to plan this land was received from the Israel Lands Administration.

As at the date of publication of this periodic report, of these properties, 52 are jointly held with the Ministry of Communications and/or the Postal Authority (now the Israel Postal Company Ltd.). On June 30, 2004, The Company entered into an agreement with the Postal Authority to define and clarify the rights of both in these properties (see Section 2.17.2(c) below). The parties are following the provisions of the agreement, *inter alia*, to separate joint charges and systems.

In addition to these 425 properties, as at the date of publication of this periodic report the Company holds some 70 properties in Israeli settlements in Judea and Samaria, in a total area of approximately 9,600 m^2 of land, on which about 1,700 m^2 is built up. No written arrangement of the contractual rights in these properties exists, but in the Company's opinion, this does not constitute a significant problem.

The Company uses this land for communications operations (switchboards, concentration rooms, broadcast sites, etc.) and for other operations (transmitters, warehouses, etc.). Some of the Company's properties are undeveloped or partially developed, and can be exploited further.

As at the date of publication of this periodic report, the Company leases about 130 land assets, with a total area of 70,000 m^2, of which 65,000 m^2 are built-up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (i.e. in order to erect transmitters and deploy cables). The Company also has about 330 concentration rooms at its disposal (rooms for cables and installations for the purpose of neighborhood communications), with a total area of approximately 4,400 m^2, most of which are not regulated by written arrangements of rights with the owners (such as: The Israel Lands Administration, settling organizations, entrepreneurs of projects on which the properties are situated, and cooperative house committees).

B. Registration

As of the date of this periodic report, the Company's rights in a considerable portion of its land assets are not registered with the Land Titles Registration Office and are therefore merely contractual rights. The Company is in the ongoing process of registering those land assets which can be registered in the Land Titles Register.

C. The Settlement regarding the Land

On March 10, 2004, the Settlement signed by the Company, the Israel Lands Administration (hereinafter: "ILA") and the State was given the force of a judgment after a drawn out dispute over most of the real estate assets transferred to the Company under the real estate transfer agreement which was executed when the Company began its commercial operations. The settlement provided that the assets that remain in the Company's possession have the status of a capitalized lease. The settlement agreement also provides that 17 properties specified in the agreement will be returned to the State through the ILA on various dates (by 2010) and in accordance with the terms stipulated in the agreement.

As at the date of publication of this periodic report, the Company has returned 14 properties to the ILA. Three additional properties will be returned to the ILA after the Company receives substitute properties, in accordance with the settlement agreement.

D. Realization of real estate assets

The total assets sold by the Company over the years (both prior to and after the settlement agreement) until December 31, 2007 amounts to approximately 45 properties (in whole or in part), of which some 10 properties were sold during 2007, as set out below.

Further to the renewed examination done by management of the Company with respect to realization of its real estate assets, the board of directors approved the continued sale of inactive real estate assets and/or assets that can be relatively easily vacated, without incurring significant expenses, in accordance with lists presented to it from time to time. Likewise, the board of directors approved a detailed working procedure with respect to the sale of the Company's real estate assets, and a procedure for approving such transactions. The board of directors also resolved to postpone improvement operations on the Company's properties at this stage.

During the course of 2007, the Company sold 10 real estate assets in a total area of approximately 25,000 m^2 in land and approximately 13,000 m^2 built-up, for a total sum of $ 32.1 million (at an average exchange rate of NIS 4.2 to the dollar).

2.8 Intangible assets

2.8.1. The Company's general license

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

2.8.2. Trademarks

The Company uses trademarks that reflect its products and services.

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

"Bezeq" – Company name.

"**B**" – The Company's logo (see section 2.6.7 above).

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

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

2.9 Human Resources

2.9.1 Organizational Structure and Employees According to Organization Structure[14]

During 2006 and 2007, the Company worked in coordination with the workers' organization in order to bring about a change in the Company's organizational structure, with the aim of making the Company compatible with the competitive market in which it operates, by focusing on the customer and achieving operational and procedural efficiency.

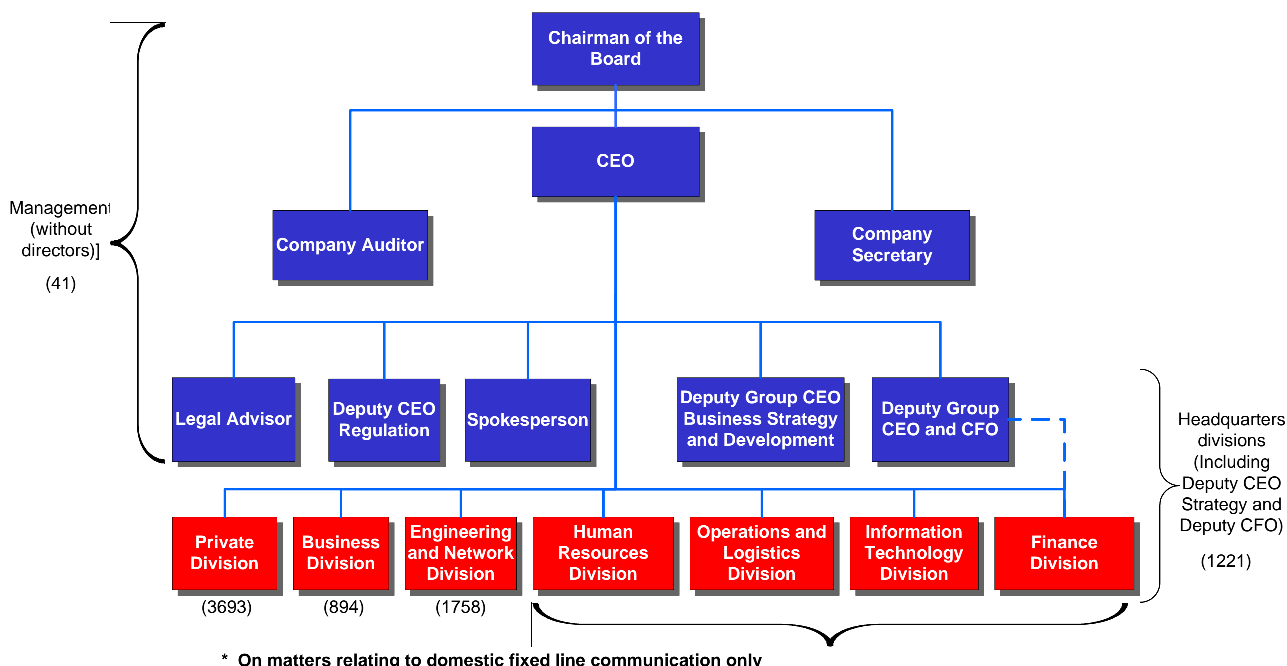
On December 5, 2006, a special collective agreement was signed between the Company and the workers' organization and the New General Trade Union, setting out the employment relationships at the Company following transfer of control of the Company from the State of Israel to Ap. Sab. Ar. Holdings Ltd.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

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

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

As at the date of publication of this periodic report, management of the Company and the employees' representation are formulating an amendment to the new collective agreement, mainly with respect to bringing forward completion of implementation of the organizational structure (with various, insubstantial changes), and with respect to bringing forward retirement dates and changing the mix of those persons who are supposed to retire under the new collective agreement by 2008 (increasing the number of early retirees as opposed to those retiring with severance pay).

The following is a diagram of the Company's general organizational structure:



On September 4, 2007, the board of directors of the Company resolved, pursuant to section 50(a) of the Companies Law, 5759-1999, and in accordance with articles 119 and 121.1 of the Companies articles of association, that the CEO's powers with respect to the corporations held directly or indirectly by the Company (including Pelephone Communications Ltd., Bezeq International Ltd., DBS Satellite Services (1998) Ltd., Walla! Communications Ltd., Bezeq Online, Bezeq Zahav Holdings Ltd., and BezeqCall Ltd.) shall be transferred to the board of directors, and the board of directors has passed resolutions regarding implementation of the above.

2.9.2 Personnel according to employment framework

Description of Employment Framework	Number of Employees	
	As at December 31, 2007	As at December 31, 2006
Senior managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.	87	89
Permanent employees employed through collective bargaining agreements.	3,315	3,926
Employees employed through personal contracts that are not part of the collective bargaining agreements.	695	1,116
Employees employed under detailed agreements under collective agreement conditions ("rank rating contracts").	341	279
Employees engaged in defined activities, which in the past were staffed by workers from employment agencies. The conditions of employment of employees in this category were recently updated in the special collective agreement of December 5, 2006 ("Generation 2000 Employees").	55	2,241
Employees employed under the special collective agreement of December 5, 2006, hourly.	2,192	376
Employees employed under the special collective agreement of December 5, 2006, monthly.	926	3
Other	3	46
Total	**7,614**	**8,076**

Notes: (1) The report as at December 31, 2006 was updated retroactively in accordance with changes in the status of employees, and subtracting employees recruited on January 1, 2007. (2) During the course of 2007, changes were made to employment frameworks (employee sub-group) in accordance with the new collective agreement. Former Generation 2000 Employees are included under the **hourly collective agreement** as are employees under the former

temporary hourly agreement and new employees recruited for hourly employment. Former Generation 2000 employees who were hired to do jobs that are monthly by nature are included under the **monthly collective agreement**, as are employees under former total salary contracts and new employees recruited for monthly employment. As at December 31, 2007, the number of employees includes 7 employees who have not yet been placed in jobs, and who are not part of the organizational structure set out in section 2.9.1 above.

Note that out of 975 employees who are supposed to terminate their employment at the Company between 2006-2008 under early retirement tracks or increased severance pay tracks, under the collective agreement of December 5, 2006 (see section 2.17.4(f) below), the following employees have retired:

Period	Retirements during the Period	Aggregate retirements
Up to March 31, 2007	399	399
Up to June 30, 2007	275	674
Up to September 30, 2007	47*	721*
Up to December 31, 2007	171	892

* Adjusted due to postponement of planned date of retirement of 5 employees.

2.9.3 Orientation and retirement of employees from January 1, 2007 through December 31, 2007

Employment Framework	Intake	Retirement
Senior managers	16	27
Permanent employees	-	783
Employees under other employment arrangements	1,877	1,545
Total	**1,893**	**2,355**

Note that between January 1, 2008 and February 29, 2008 approximately a further 280 employees retired from the Company (of whom, 44 were permanent employees).

2.9.4 Company's investment in further study, training of employees and higher education

The Company conducts internal training sessions given by professional experts who are Company employees and at times, with the assistance of external organizations, in all its areas of activity. Total work days allotted to training of all employees during 2007 – approximately 43,500. days, or an average of 5 training days per employee. This training activity includes, professional training in the fields of technology, sales, management, service and others.

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

Total investments by the Company in the above activities in 2007 amounted to approximately NIS 6 million, over and above the cost of work days of employees with respect to training and study days.

2.9.5 Nature of employment agreements at the Company

Labor relations at the Company are regulated, in addition to regulations in labor legislation, by the collective bargaining agreements between the Company, the representatives of Company employees and the New General Federation of Labor (hereinafter: "Histadrut") and personal contracts. Additionally, expansion orders to certain general collective bargaining agreements apply to Company employees. These include agreements on cost-of-living allowance.

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

2.9.6 Employee Reward Schemes

2.9.6.1 Employee option plan of 2005

On November 15, 2005, the Company published an outline of an offer of the State's shares to employees of the Company. The offer is for up to 122,697,648

options, exercisable for up to 122,697,648 shares of the Company held by the State of Israel and constituting approximately 4.71% of the shares in the Company, and exercisable in three equal portions after approximately two years, three years and four years following the date of allotment. As of January 1, 2008, the employees are entitled to exercise the first instalment of the plan. In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

2.9.6.2 Employee option plan of 2007

On February 22, 2007, the board of directors of the Company approved an employee option scheme and on the same date, the Company published an outline with respect to the scheme. Under the scheme, the Company shall issue its employees with options exercisable for shares at 3% of the issued share capital of the Company, at an exercise price (adjusted for each kind of distribution etc.), of 50% of the last closing price of the share prior to the date of issue, (apart from senior management staff), for no consideration, in accordance with criteria prescribed in the collective agreement of December 5, 2006.

Accordingly, on March 25, 2007, the Company allotted 78,091,794 options (out of a total sum of 78,151,368 options[15]) to employees, exercisable for 78,091,794 ordinary shares of the Company of NIS 1.00 par value each at an exercise price of NIS 3.201 per share, linked to the CPI for February 2007 (adjustments for all kinds of distributions etc. shall apply to the exercise price). The options shall be blocked for a period of two years as of the date of issue of them, and shall be exercisable over three years from the end of the blockage period.

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

2.9.6.3 Option plan to senior managers and employees of the Group, of November 2007

On November 20, 2007, the board of directors of the Company resolved to adopt an option plan for managers, senior employees at the Company and/or affiliates under which up to 65,000,000 non-negotiable options exercisable for up to 65,000,000 shares of the Company and constituting approximately 2.5% of the issued share capital of the Company, or under full dilution, approximately 2.36% of the share capital, would be allocated.

The options will vest in three equal annual instalments. The vesting dates of each instalment shall fall at the end of each of the first year, the second year and the third year after the date of grant, accordingly.

The exercise price of each option is NIS 5.50, and it reflects a discount of approximately 16.8% compared with the closing price of the Company's shares on the Tel Aviv Stock Exchange on January 31, 2008, the date of general meeting approval.

The allocation under the plan shall be under the capital gain track, with a trustee as set out in section 102(b)(2) of the Income Tax Ordinance [New Version], 5721-1961.

The option plan and allocation of all of the options under it were approved by the general meeting of the Company on January 31, 2008, in accordance with the

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[15] The rest of the options (59574 options) were allotted on January 2, 2008 to two employee directors following approval of the allotment by the general meeting of the shareholders of the Company, at an exercise price of 50% of the share price on the date of allotment of the options (exercise price of NIS 2.9991 per share. The total value of the benefit is approximately NIS 237,006 as at October 21, 2007. See also the immediate report of the Company of October 29, 2007).

articles of association of the Company. Exercise of the options under the plan is conditional upon obtaining the appropriate consents under the provisions of the Communications (Telecommunications and Broadcasts) (Prescription of Essential Service provided by Bezeq, The Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the "Telecommunications Order"), or via some other solution that will enable shares in the Company to be allocated in compliance with the provisions of the Telecommunications Order, and such exercise might require amendment of the Telecommunications Order.

On December 25, 2007, the Company published an outline of an allocation of options from the plan in accordance with the Securities (Details of Outline of Offer of Securities to Employees) Regulations, 5760-2000, setting out the conditions of the plan, inter alia, and a report of private placement under the Securities (Private Placement of Securities in a Listed Company) Regulations, 5760-2000.

Accordingly, as at the date of publication of this periodic report, 40,100,000 options exercisable for up to 40,100,000 shares have been offered under the option plan, including to the CEO of the Company[16].

The theoretical economic value of all of the options included in the plan, relying on a weighted B&S model, is approximately NIS 187 million, whilst the theoretical economic value of all of the options approved and/or issued (45,700,000 options) is approximately NIS 134 million, in reliance, inter alia, on the share price on the date of issue (for the options approved and/or issued) and on the share price close to the date of approval of the financial statements (for options not yet approved or issued), a risk-free annual interest rate of between 5.11% and 5.24%, the exercise price set out above, an annual standard deviation of between 22.35% and 24.20% and the limitation described above under the Telecommunications Order. The Company has not yet made a decision regarding the exercise price of future options that may be issued, if at all, under the plan.

In this regard, see also Note 26 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 16 directors[17] and 15 senior executives.

The two external directors acting on the board of directors of the Company receive remuneration in accordance with the Companies (Rules Regarding Remuneration and Expenses of an External Director) Regulations, 5760-2000. The other directors of the Company do not receive any remuneration or salary for their office as directors. The conditions of employment of the chairman of the board of directors have not yet been concluded or approved by the competent entities in the Company.

For the management agreement between a management company owned by the shareholders of Ap. Sab. Ar., see section 2.17.5 below and Note 29(e) to the Company's financial statements for the year ending December 31, 2007, included in this periodic report.

The senior members of management are employed under personal agreements which include, *inter alia*, pension coverage, the payment of bonuses based on goals and prior notice months. The Company also gives options for shares of the Company to members of senior management, in accordance with its discretion (see section 2.9.6 above).

With respect to grants to office-bearers – following the recommendations contained in the report of the external examiner, Dr. Yoram Danziger, dated April 26, 2007 (see section 2.20 below), on May 22, 2007, the board of directors of the Company approved grants to office-bearers for 2006 in the total sum of NIS 1,059,566. In addition, the board of directors at the same meeting approved the award of grants to office-bearers for 2005 in the total sum of NIS 210,000.

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[16] On March 10, 2008, the board of directors of the Company approved an issue of 5,600,000 additional options convertible to 5,600,000 shares of the Company to senior managers of the Group. These options have not yet been issued.

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

In addition, on May 22, 2007, following the consent of the Audit Committee in its meetings of May 15, 2007 and May 22, 2007, the board of directors approved grants to a number of officers. The Company reported these grants in an immediate report on May 22, 2007. Some of the officers repaid the Company the difference (if any) between the grants that they received in the past and the grants approved to them as aforesaid. The total repayment is approximately NIS 590,000 (all of the sums set out above are in gross terms – before tax).

With respect to the grants unlawfully paid to the former CEO of the Company, Mr. Yacov Gelbard, for 2005 and 2006, his undertaking to repay these to Pelephone and the Company, respectively, remains in force. The Company passed a resolution to the effect that if these grants are not repaid to the Company, it shall take such legal steps as are required to collect the debt.

For 2007, payment of grants to members of senior management was approved in the total sum of approximately NIS 4 million. With respect to the CEO and the VP Engineering and Networks, the aforesaid sum also includes grants for the period in which they worked in a subsidiary prior to commencement of employment at the Company.

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

2.10.1 The main raw materials used by the Company are: exchanges, copper cable, fiber-optic cables, transmission equipment, data communications systems and equipment, servers, routers and XDSL routers. The Company purchases most of the equipment required for its communications infrastructures from Israeli companies connected with communications equipment manufacturers from around the world. The Company purchases hardware and software from a number of main suppliers. Most of the equipment purchased for data communications, switching, transmission and radio systems was unique equipment, and it has only been possible, over the years, to receive support services from the manufacturer (in this regard see also section 2.10.3 below).

2.10.2 As at the date of this report, the purchases from no sole supplier to the Company amount to more than 5% of total purchases in any area of operations.

2.10.3 In the Company's opinion, it is dependent, in the field of public switching equipment, on the Alcatel Group which is represented in Israel by Alcatel Telecom Israel Ltd. In the field of collection systems for business customers the Company is dependent on Amdocs Software Systems and in the field of transmission, on ECI.

As for the Company's relationship with the Nortel Group, which is represented in Israel by Nortel Israel (Sales and Marketing) Ltd., the Company and Nortel have an upgrade and maintenance agreement for switches manufactured by Nortel, which was in force until the end of 2007. Prior to termination of the term of the agreement, a comprehensive examination was performed at the Company and it was found that in light of the Company's experience in operating Nortel switches, and in light of the low probability (based on past experience) of faults that the Company is unable to solve by itself, and in light of the very high costs involved in renewing the agreement, it would be more correct not to renew the contract under the proposed conditions. As a result, the Company's dependence on Nortel dropped.

2.11 Working capital

2.11.1 The cash and cash equivalents component and short-term investments in working capital are generally significant and designed to allow the Company flexibility in its activities.

2.11.2 The inventory purchased by the Company is for the most part intended for investment in fixed assets. The Company's inventory policy strives to maintain an inventory sufficient for the Company's needs for average consumption from time to time, with flexibility for special cases according to the nature of the consumption and price of the item. Orders from suppliers are made taking into consideration past demand and forecasts for the future.

2.11.3 The following table presents data on supplier and customer credit in 2007:

	Scope of average credit in NIS millions	Average credit days
Customers	918	EOM + 16
Suppliers	346	EOM + 29

2.12 Investments

For information on investments in subsidiaries, see Note 33 to the financial statements for the year ended December 31, 2007, which are included in this periodic report. See also Sections 3 and 4 in Chapter D of this periodic report.

2.13 Financing

2.13.1 Average interest rate on loans

As at 31 December 2007, the Company is not financed by any short-term credit (less than one year).

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

Source of financing	Type of currency or linkage	Rate of average interest
Non-banking sources[18]	CPI linked NIS	4.38%
	NIS-Linked Euro[19]	5.14%

2.13.2 Restrictions on receipt of credit

A. With respect to limitations on Company loans – see Note 13 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

B, Bank of Israel Restrictions regarding Sole Debtor and Group of Debtors

Directives issued by the Supervisor of Banks in Israel include provisions according to which the liability of an individual borrower or group of borrowers for a banking institution shall not exceed 15% (individual borrowers) and 30% (group of borrowers) of the banking institution's capital. These provisions further stipulate that total liabilities of the banking institution's six largest borrowers and groups of borrowers shall not exceed 135% of the banking institution's capital. These provisions may, from time to time, affect the ability of some banking institutions to issue additional credit to the Company. However, as a rule, the Company does not have difficulty finding sources of finance. As the Company does not have data and exact information regarding the restrictions on individual borrowers that apply to the banks, and given the fact that the Company cannot quantify the number of debentures issued by the Company and held by the banks, the Company is not able to estimate when and at what level of debt, if at all, these restrictions will impact on the Company's ability to secure credit.

2.13.3 Credit received during the reporting period

During the period between May 27, 2007 and July 16, 2007, the Company raised approximately NIS 1,200 million in a number of fundraising operations by selling 1,070 million par value debentures (series 5) of the Company. These debentures were sold by the subsidiary Bezeq Zahav (Holdings) Ltd. ("**Bezeq Zahav**") and the aforesaid proceeds were transferred to the Company in repayment of a loan granted by the Company to Bezeq Zahav for the purpose of acquiring the above debentures. The fundraising was effected at an average interest rate of 3.71% (the debentures are CPI linked). See also section 2.13.7 below.

2.13.4 Credit received after December 31, 2007

The Company has not taken any loans since December 31, 2007.

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[18] On August 8, 2007, the Company repaid the principle of the Eurobonds that it issued in 2000, in the total sum of 293 million Euro.

[19] During the month of January 2008, the Company repaid Euro-linked NIS loans and the Company does not now have any loans that are linked to foreign currency.

2.13.5 Variable interest

The following table outlines the Company's loans and debentures with variable interest rates (in NIS millions, as at December 31, 2007):

Type of linkage	Change mechanism	Financial scope	Interest range in 2007	Current interest rate
Euro and Euro-linked[20]	Libor – EUR 6M	30	4.05%-5.14%	5.14%

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

2.13.6 Credit rating

The Company is rated by four credit rating agencies. The following are details of the rating given by each of the rating companies as at the date of publication of this periodic report (including latest rating updates):

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Standard & Poors Maalot	AA	May 1, 2007 – Standard & Poors Maalot gives notice that pursuant to disclosures and to the investigation report of the External Examiner (see section 2.20 below) regarding depreciation of plant & equipment at Pelephone, no change is expected at this stage in the rating of the Company's undertakings. In this regard, see also section 3.15.6 below.	All series of debentures
Midroog	Aa1	April 11, 2006 – rating taken off the Watch List and left at Aa1. Rating forecast lowered from stable to negative so as to reflect the possibility that a change in ownership of the Company might affect the Company's future commercial and financial profile.	Debenture series 4 and 5
Standard & Poors	BBB+	November 5, 2007 – rating left unchanged: BBB+ with negative rating forecast.	The rating is for the Company
Moody`s	Baa1	February 6, 2006 – rating left at Baa1 and held to be stable.	The rating is for the Company

2.13.7 Estimate of raising funds in the coming year (2008) and sources of financing

The Company expects to repay some of its loans during 2008. If necessary, the Company will raise additional debt in 2008.

The financing options open to the Company are: Raising debt by the sale of series 5 debentures held by a wholly-owned subsidiary, Bezeq Gold (Holdings) Ltd., raising debt by new loans from banking corporations and/or by raising debt or capital on the capital market.

2.13.8 Liens and guarantees

For information regarding the Company's liens and guarantees, see Notes 13 and 19 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

2.14 Taxation

For information regarding taxation, see Note 8 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

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[20] See footnote 19 above.

2.15 Environmental matters

2.15.1 <u>The Non-Ionized Radiation Law, 5766-2006 (the "Law")</u>

The Law regulates the handling of sources of electromagnetic radiation (hereinafter: "Radiation Source"), the erection and operation of them and supervision of them. *Inter alia*, the Law provides that the erection and operation of a radiation source will require a permit; imposes penal provisions and severe provisions with respect to liability of officers; imposes recording and reporting obligations on a permit-holder and grants the Commissioner for Radiation supervisory powers, including with respect to the conditions of the permit, cancellation of the permit and removal of the Radiation Source. Note that the Company's installations, such as broadcast installations or wireless communication installations, are included under the definition of Radiation Source. Prior to enactment of the Law, the provisions of the Pharmacists (Radioactive Elements and By-Products) Regulations, 5740-1980 applied to the Company's facilities which emit electromagnetic radiation, and these regulations were not repealed by the Law.

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

During the course of 2007, the Company acted to obtain operating permits from the Commissioner for Non-Ionized Radiation at the Ministry of the Environment (the "**Commissioner**"), all in accordance with the Law. Following these operations, the Company received operating permits for communications facilities including for broadcast sites that it operates. With a few exceptions, on the date of filing the application for operating permit under the Radiation Law, there was a valid permit in place under the Pharmacists Regulations. As at the date of publication of this periodic report, the process of issue of the operating permits by the Commissioner is being delayed due to a strike at the Ministry of the Environment.

Note that the Commissioner may require building permits as a condition of the continued validity of the operating permits for communications facilities (including broadcast facilities) granted by him. Likewise, the Commissioner may require an affidavit of exemption from a building permit for "wireless access facilities" which have a "class approval" given to the Company by the Commissioner. See also section 2.16.11 below.

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

New regulations regarding non-ionized radiation which were approved on October 23, 2007 by the Interior and Environment Committee of the Knesset, and which require the consent of the Ministers prescribe, inter alia, payment of fees for the filing of an application for a radiation source permit. Following approval of the regulations, the Company is expected to be required to pay fees in a non-substantial sum, which will be payable over a number of years. These regulations also prescribed a new method of calculating safety ranges for radiation sources.

2.15.2 With respect to permits for broadcasting installations that are required by the Planning and Building Law, 5725-1965, see Section 2.16.11 below.

2.15.3 With regard to claims filed regarding alleged radiation from the Hillel broadcasting station – see Note 17(a)(5) to the financial statements for the year ended December 31, 2007, which are included in this periodic report.

2.16 Restrictions on and regulation of Company operations

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

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

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

A. The tariffs for the Company's supervised services, stipulated in said regulations are updated using a linkage formula, less an efficiency coefficient, as set forth in the regulations and based on the recommendations of public committees for the review of the Company's tariffs.

On June 1, 2007, the Communications (Telecommunications and Broadcasts) (Payments for Telecommunications Services) Regulations, 5767-2007 and the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) (Amendment) Regulations, 5767-2007 came into force. Under these regulations and based on the draft tariff update set out in the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) Regulations, 5763-2003, the reduction of the Company's supervised tariffs as of June 1, 2007, was at an average rate of approximately 3.13%. This reduction is based on a reduction of approximately 0.1% in the consumer price index less the average rationalization coefficient at a rate of approximately 3.038%. Likewise, the Communications (Telecommunications and Broadcasts) (Payments for Interconnect) (Amendment) Regulations, 5767-2007 came into force on the same date, under which the reduction of interconnect tariffs as of June 1, 2007 was at a rate of approximately 4.01%.

The tariff arrangement set by the latest public commission (the Grunau Commission) commenced in 2003 and was supposed to end at the end of 2007. Despite the fact that no formal notice was received regarding extension of this arrangement, under the Linkage Regulations and the amendment thereof (as set out above), another update of the supervised tariffs is supposed to take place on June 1, 2008, however, as at the date of publication of this periodic report, there is uncertainty as to the performance and force of the update and the Company is unable to assess what the implications of the above might be.

B. Pursuant to section 15A of the Communications Law, if tariffs are stipulated for the supervised services under the above section 15, the Minister may, with the consent of the Minister of Finance, approve the request made by the Licensee for an "alternative payment basket" for a package of services.

In December 2007, five alternative payment baskets were approved for the Company which are relevant to the private sector, and in February 2008, another such payment basket was approved.

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

D. On June 7, 2007, the Communications (Telecommunications and Broadcasts) (Payments for Telecommunications Services) (Amendment) Regulations, 5767-2007 were signed under which the criterion for entitlement to reduced usage fees was changed from entitlement under the criterion of reduced use to entitlement granted to a person who receives a pension under the Income Assurance Law, 5741-1980, about whom the National Insurance Office provides the Company with details, and who only has one subscriber telephone line registered in his name, in an apartment that is used for residential purposes only. This change is not expected to have a substantial impact on the Company's income.

2.16.2 The Company's general license

The Minister's policy paper

On March 31, 2004 a comprehensive and far-reaching amendment was made to the Company's general license, by virtue of which the Company, *inter alia*, operates. The then Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages, as follows:

Volume discounts - Once a competing domestic operator begins providing commercial telephony services, the Ministry will permit the Company to grant volume discounts of no more than 10% of the payment stipulated for the service, under Section 15 of the

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

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

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

With respect to market share – on November 25, 2007, the Ministry gave notice to all domestic licensees of the measurement methods prescribed by the Ministry, under which updates are sent to the licensees in the field of domestic fixed-line telephony. According to the last report provided by the Ministry on February 20, 2008, the Company's market share (in normative revenue terms) is 88.2% of the private sector and 92.6% of the business sector. In the Company's assessment, and presuming that the current trend continues, the Company's market share (in normative revenue terms) will fall below 85% in the private sector only during 2008. With respect to the business sector, the Company is unable to assess when it will reach such a market share. According to the Minister of Communications' policy letter – if and when the Company reaches this market share, it will be able to market joint service bundles as described above.

The information in the above paragraph includes forward-looking information, based on the Company's assessments. Actual results might be substantially different from these assessments.

Main Points of General License

A. Scope of License and Obligation to provide Service to All (Universal Service Obligation)

The Company is mandated to supply basic services, ancillary and other services as set forth in the appendix to the license; the term of the license is not limited in time; the license anchors the Minister's existing powers under the Law, to modify, revoke and suspend the license; the Company is required to supply its services to all persons (the universal service obligation), on equal and nondiscriminatory basis with respect to each class of service, regardless of the location or the unique cost.

B. Rules of structural separation

The Company must establish a structural separation between it and a "subsidiary", the definition of which, for this purpose, includes Pelephone, Bezeq International, DBS, Bezeq On-line, and Bezeqcall Communications, and GoldNet which have, in the meantime, been merged into Bezeq International. (The Minister has the authority to expand the application of the rules of structural separation to an affiliated company[21], if it has been established that there is a real fear of injury to competition or to the

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

public). Full separation is required between the managements of the various companies, including with respect to the business system, the finance system and the marketing system; full separation of assets; prohibition against employing the Company's employees at a subsidiary, and employees of a subsidiary at the Company (as at the date of publication of this periodic report, a small number of employees remain who were loaned, in the past, from Bezeq to Bezeq International and BezeqCall, due to an arrangement in the Company's previous general license, and following the merger with Pelephone, Bezeq International now bears the costs of employment of these people); prohibition against the transfer of commercial information to a subsidiary (the definition of "commercial information" having been expanded to include commercial information regarding the Company as well). No employee of the Company may be appointed a director of a subsidiary, if, within the scope of his duties in the Company, he has access to "commercial information" concerning a competitor, the use of which by the subsidiary could damage competition between it and the competitor. This limitation on appointment does not apply to the chairman of the board of directors of the Company).

The Company must set rules and procedures to preserve the confidentiality of commercial information on licensees competing with the Company's subsidiary, and it is prohibited from transferring said information to the subsidiary. The Company has set such rules.

C. Tariffs

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

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

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

With respect to billing by standing order, credit card, prepayment or deposit of a guarantee, it has been prescribed that the Company is not entitled to require that payment necessarily be made in those manners.

D. Investments in other fields and restrictions on cooperation

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

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

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

E. Numbering and number portability

It has been prescribed that the Company is to operate in accordance with the numbering plan and with the provisions regarding activation of number portability. For the numbering plan and number portability, see section 2.6.6A above.

F. Operation of Company networks and service levels

The Company must maintain and operate the network and provide its services 365 days a year, around the clock, including at times of emergency, in a regular and proper manner, commensurate with technical requirements and service quality. The Company is also bound to work towards improving its services. The Company's general license includes an appendix regarding the "level of service for subscribers", which is to be amended after the Company provides the Ministry with data. The Company provided the Ministry with a proposal to amend the Appendix, adjusting it to the current state of affairs and the licenses of other carriers, but this amendment has not yet been made.

G. Interconnectivity and use

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

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

H. Arrangements in the field of security

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

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

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

I. Liability and insurance

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

J. Control and reporting

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

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

K. Miscellaneous matters

The general license includes "cross-ownership" restrictions.

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

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

The Company must provide a bank guaranty to secure performance of the license conditions and indemnify the State for any damage that may be incurred by it following the breach thereof, such guarantee to be in an amount equal to US$10 million. The Company has furnished the guarantee as required. The Minister may forfeit the guarantee or part thereof under the conditions set out in the license (note that the Ministry of Communications has in the past exercised this power with respect to the Company. In this regard, see also Notes 13(c) and 19(a) to the Company's financial statements for the period ended December 31, 2007, which are included in this periodic report).

Under the provisions of the Law, the Minister of Communications has the authority, at any time, to revoke, limit or suspend a license, if, for among other reasons, performance of telecommunications activity or provision of telecommunications services by a Licensee do not conform with the standard and at a proper level of similar activity or service, in accordance with the rules stipulated in the Law, or if the Licensee is in material breach of the terms of the license.

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

At the end of 2004, the Ministry of Communications began a process of horizontal amendments of the general licenses, including with respect to the level of service offered to subscribers. The Company had provided its comments on the proposed amendments, but the process is not yet complete.

2.16.3 Royalties

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

The Telecommunications (Royalties) Regulations, 5761-2001 (hereinafter: the “Royalties Regulations”), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscriber services in the Schedule to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. On August 31, 2006, an amendment of the Royalties Regulations was published regulating the reduction of the royalty rate for all royalty-owing licensees, commencing on January 1, 2006, by a rate of 0.5% per annum, up to a rate of payment of royalties of 1% per annum as of 2010. The royalty rate in 2007 was 2.5% compared with 3% in 2006.

On December 31, 2007, a draft amendment of the Royalty Regulations was submitted for the approval of the Finance Committee of the Knesset by the Ministers of Finance and Communications. The draft added a section exempting a domestic carrier from paying royalties for income from the provision of data communication services, management of a data communications network and PTP lines at high baud rates and certain types of links, where one of the parties is a corporation, as of January 1, 2004. Likewise, the amendment contains a provision regarding deduction of revenues and payments from the basis of royalty-attracting revenues, under which a licensee is not entitled to deduct an income component if such component is not included in the calculation of royalty attracting revenues, and the licensee is not entitled to deduct payments unless they are not ascribed

to income included in the calculation of royalty attracting revenues. The amendment also contains an exemption from payment of royalties for the revenues of international carriers from data communications services, the duty to pay arrearage interest in the event of consolidation, and an amendment of the definition of "licensee" so as to include a broadcast licensee, in order to enable a domestic carrier to deduct its revenues from the provision of transmission services, even when the service is provided to a broadcast licensee.

2.16.4 Authority with respect to real estate

According to the provisions of Section 4(F) of the Communications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law. Until the Law was amended in 2001, this Chapter did not distinguish between public and private land, and enabled the Company and the persons it authorized for purposes of providing telecommunications services, to enter any real estate in order to carry out surveys and examinations required for planning a telecommunication installation, and for examining, repairing or making changes thereto or therein. In most cases, prior notice was required to be given to the occupier of the real estate and the latter could appeal to the Court.

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

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

2.16.5 Immunities

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

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

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

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

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

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

(2) Due to an error in providing a telecommunications service, an error in a telecommunications message or an omission therefrom, failure to transmit a telecommunications message or delay in transmission thereof, delivery of a telecommunications message to an incorrect address or erroneous recording in a subscriber directory or other publication of the holder of immunity, unless done with grievous negligence.

Under Section 13 of the Law which relates to the provision of telecommunications services to the security forces, a licensee or any of its employees shall bear no criminal or civil liability for any act committed in the performance of a direction to be given according to said Section, except in circumstances in which the State employee bore liability for the act. (Under the Civil Wrongs Ordinance, in any action other than negligence, a public servant will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority).

2.16.6 Regulations and rules under the Communications Law

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

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

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

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

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

The Company acts to locate debtors and to collect debts from its customers. In cases where debts are not paid, legal action is usually taken through external lawyers.

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

On February 6, 2008, a draft of regulations regarding the set-up of an 'exceptions committee' with the purpose of examining requests by Bezeq or Hot for an exemption or delay in providing or installing services (as the case may be) and to make recommendations to the Minister of Communications regarding the grant of such exemption or delay or otherwise, was provided to the Company and Hot for comment. The Company has provided the Ministry with its response.

2.16.7 Antitrust laws

A. On June 27, 1995, the Antitrust Commissioner (hereinafter: the "Commissioner") declared the Company to be a monopoly in the following areas: Basic telephone services, provision of communication infrastructure services, unlimited bi-directional international telephone services (including service for incoming calls) and transfer and transmission broadcasting services to the public.

   The Commissioner's declaration of the Company as a monopoly constitutes *prima facie* evidence of the terms thereof in any legal proceeding, including criminal proceedings. Therefore, a plaintiff - being a person or consumer organization - who

seeks to sue the Company either by a personal civil action or class action will be excused from proving the fact that the Company is a monopoly, to the extent this proof is relevant for its claim, in reliance on the Commissioner's declaration, and the Company will have to discharge the burden of proof in rebutting the contents of the Commissioner's declaration in this respect.

B. At the end of 1995, the Company transferred its activity in the field of provision of international telephone services to Bezeq International and as a result, Bezeq International "inherited" the Company's monopolistic position in this market. On April 29, 2001, the Commissioner decided to cancel the declaration of Bezeq International as a monopolist in the field of provision of international telephone services, due to the competition that had emerged in this market.

C. In light of the changes and developments which have occurred in the communications market overall, and particularly in the field of "basic telephone services", especially in light of the increasing competition in the field of this service compared with the cellular telephone companies, the Company applied to the Commissioner on March 6, 2000, requesting the cancellation of his declaration of the Company as a monopoly in the field of "basic telephone services".

The Company filed an appeal on September 9, 2001 against the Commissioner's decision not to cancel said declaration. Subsequently, the Company consented, at the suggestion of the court (in view of the time elapsed since the appeal, with an accompanying economic opinion, was filed), to withdraw the appeal, and it was struck out on August 2, 2006.

D. On December 11, 2000, the Commissioner declared the Company a monopoly in the field of “telecommunications infrastructure for the provision of high-speed access services via internet service providers”.

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

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

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

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

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

G. On May 23, 2006 and thereafter, searches were conducted in the offices of the Company by staff of the Antitrust Authority, and a number of employees of the Company were interrogated with respect to suspicions of abuse of monopolist status and/or unreasonable refusal to supply an asset or service under a monopoly.

Subsequently, the Antitrust Authority gave notice that the investigation of the matter had ended.

H. On December 24, 2007, the Antitrust Commissioner issued a ruling by virtue of his powers under section 43(a)(5) of the Antitrust Law, stating that Bezeq had abused its status in the market in contravention of the provisions of section 29A of the Law in failing to respond as required and on time to steps taken by its employees during the course of a labor dispute relating to the operations of other communications carriers, and in not being prepared, according to the ruling, to immediately apply to the Labor Court with respect to the disconnection of its network from that of Hot. Note that Bezeq filed its application for an injunction to the Labor Court in the afternoon of May 18, 2006, the day following the date of the fault in Hot’s network (May 17, 2006 in the afternoon).

The ruling further states that pursuant to section 43(e) of the Antitrust Law, the ruling itself will be prima facie evidence of the prescription in it in any legal proceedings, and that pursuant to section 43(f) of the Law, the Commissioner's exercise of power under section 43, or lack thereof, shall not constitute any obstacle to trying any person who violates the provisions of the law.

The Company intends to file an appeal against the ruling. With respect to this matter and to the matter of the class action regarding the issue, see Notes 17(a)(12) and 17(c)(1) to the financial statements of the Company for the year ended December 31, 2007, included in this periodic report.

I. For the application for exemption from approval of an arrangement in restraint of trade regarding telephone number information services, see update to section 2.2.2 above.

J. On October 18, 2007, the Company gave the Antitrust Authority data and documents at the Authority's request regarding the alleged provision of information to a subsidiary.

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

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

2.16.8 <u>The Wireless Telegraphy Ordinance</u>

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

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

The Company and the Ministry of Communications have a number of differences of opinion regarding fees which the Company claims it does not owe and therefore has not paid. Following a clarification with the Ministry regarding these disputes, most of them have been settled. The main sum remaining in dispute relates to fees in Judea, Samaria and Gaza, and amounts, as at December 31, 2007, to approximately NIS 48 million.

For an update on WiMAX, see section 2.6.6B above.

2.16.9 <u>Proposed Legislation to Amend the Consumer Protection Law</u>

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

According to the proposed wording, this provision will not apply to the transactions set out in the Schedule and, under the present wording, fixed line telephony is included in the Schedule. In a similar matter, the Ministry of Communications is also conducting a hearing to amend carrier licenses so that the carriers will be required to give notices to consumers

regarding termination of fixed deals, and the tariffs that will be charged subsequently. On February 10, 2008, the Company gave its comments.

A number of bills to amend the Consumer Protection Law were also placed before the Economics Committee of the Knesset, including with respect to disconnection from ongoing services, visits by technicians, a bill regarding spam mail that requires, with certain exceptions, advance customer consent to being contacted via certain electronic means, including SMS and email, and other proposals which, if accepted, might change the way in which the Company engages with its customers. The Company is unable to assess, at this stage, what amendments will be accepted and what their impact might be.

2.16.10 Arrangements in the field of security

In addition to the special provisions that apply to the Company in the field of security by virtue of the general license (see section 2.16.2H above), special provisions also apply to it under the Communications (Telecommunications and Broadcasts) (Prescription of Essential Service Provided by Bezeq, The Israel Telecommunications Corp. Ltd.) Order 5757-1977. Under this order, an observer is appointed to the meetings of the board of directors of the Company and its committees, with such security vetting and classification as prescribed by the General Security Services.

2.16.11 Establishment of communications installations - National Outline Plan 36

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

B. NOP 36A

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

As at the date of publication of this periodic report, building permits have been issued for most of the small broadcasting installations, in accordance with NOP 36A. The Company is working on taking out building permits, including via legal proceedings, for 7 small broadcasting installations. Due to intensive activities being done at the Company regarding the obtaining of permits, and due to the termination of operation of certain installations, the number and class of sites change from time to time. From time to time, the need arises to add broadcasting installations, which require the obtaining of building permits under NOP 36A (as at the date of publication of this periodic report, 10 sites are being dealt with).

(2) The NOP 36 drafting committee has decided that the distinction between NOP 36A and NOP 36B will be based on the size of the public safety range, irrespective of the size of the installation. Pursuant to this decision, under the draft amendment of NOP 36A of January 2008, the licensing process for microwave installations which were previously classified as small broadcast installations, and which have a safety range of more than 12 meters, will fall under NOP 36B, which prescribes more stringent conditions for issuing building permits.

The draft amendment of NOP 36A of January 2008 also prescribes different licensing tracks according to the location and safety range to the public of an installation, where an obligation to deposit deeds of indemnity for compensation under section 197 of the Planning & Building Law, in various indemnity sums (depending on the track) is set for each track.

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

With respect to "wireless access installations", there are a number of initiatives to cancel the exemption from a building permit. If the Company is required to provide an affidavit of an exemption from a building permit as set out in section 2.15.1 and/or if the exemption from a building permit is given, this might have

substantial adverse implications which the Company is unable to estimate at this stage. For the implications on the subsidiary Pelephone, see section 3.18.3.3 below.

C. NOP 36B

As set out in paragraph (b) above, under the January 2008 draft, the licensing process for broadcast installations previously classified as large, which have a smaller safety range than 12 meters, shall come within NOP 36A, the current draft of which does not include transitional provisions enabling an abridged licensing procedure.

The January 2008 draft proposes transitional provisions to the effect that: (1) a building permit issued for a broadcasting installation according to a previous plan which does not comply with the provisions of the NOP 36B, shall be regarded as irregular use that was permitted for a period of 24 months from the date of the approval of the Plan. If the operator of the installation submits to the institution that approved the erection of the installation, a permit from the Commissioner on Radiation of compliance with the safety restrictions prescribed in the Plan, within said period, the permit will be regarded as being in compliance with the provisions of NOP 36B. Otherwise the building permit shall expire. (2) A permit may be granted for broadcasting installations erected prior to the approval of the NOP 36B at a broadcasting site which existed prior to January 31, 1984, even if the installations do not comply with the provisions of the NOP 36B, provided they meet the safety restrictions specified in NOP 36B.

Note that the Company's broadcast installations were mostly set up many years ago (prior to January 31, 1984), some of them by authorities of the State.

The January 2008 draft also proposes including a provision requiring that an applicant for a permit from a local committee to give a deed of indemnity regarding compensation under section 197 of the Planning & Building Law, should a ruling be made against the local authority for all of the installations contained in NOP 36B, including broadcast installations erected prior to January 31, 1984, which were exempt from the indemnification obligation under previous drafts of NOP 36B. The Company has submitted its objection to the inclusion of said provision in NOP 36B.

D. General

In light of the expected change of classification of broadcast installations based on their safety range as set out above, and in light of the change in the method of calculation of the safety range under new regulations under the Radiation Law that have not yet come into force (see section 2.15.1 above), the Company is reviewing and reclassifying its communications and broadcasting installations and as at the date of publication of this periodic report, it is unable to assess the implications of the change in classification on the licensing status of its installations and the results of such.

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

The information in this section 2.16.11 includes forward-looking information, based on the Company's assessments. Actual results might be substantially different from these assessments.

2.16.12 Amendment of section 13 of the Communications Law

On December 3, 2006, an amendment to the Communications Law was published which, inter alia, granted the Minister of Communications power to give instructions to a licensee in the event of a fault or significant break in the provision of communications services, not in circumstances of an emergency.

2.16.13 On January 11, 2007, an amendment to the Communications Law was published under the Arrangements Law which contained provisions regarding the expansion of the monetary sanctions on the licensee, *inter alia*.

2.16.14 On February 4, 2008, an amendment was published to the Second Television and Radio Authority Law, 5750-1990 under which the Second Television and Radio Authority would set up and operate a digital terrestrial television (DTT) broadcast array backed up by a digital satellite array for the transmission of the television broadcasts of television

franchisees freely to the entire Israeli public, and nationally (see also section 5.1.3.3 below) so that such distribution would be effected no later than December 1, 2008. The technological change involved in the transition from analog services to digital services in the area of television might harm the Company's revenues however, at this stage, the Company is unable to assess the aggregate harm that will be caused as a result of closing the analog networks and setting up the digital network.

2.17 Substantial agreements

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

2.17.1 Agreements relating to debentures

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, bearing annual interest of 4.8%, linked (principal and interest) to the CPI for April 2004. Of these, 800,000,000 Debentures were to the public by prospectus (hereinafter: the "Prospectus") on May 24, 2004 and 400,000,000 were purchased by a wholly owned and controlled subsidiary of the Company, Bezeq Zahav (Holdings) Ltd. (hereinafter: "Bezeq Zahav Holdings") immediately prior to the Prospectus and were listed for trade according to the Prospectus.

B. Deed of trust for debentures (series 5) dated May 24, 2004

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, bearing annual interest of 5.3%, linked (principal and interest) to the CPI for April 2004. The debentures were issued prior to the Prospectus to institutional investors and to Bezeq Zahav Holdings and listed for trade according to the Prospectus.

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

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

2.17.2 Real Estate

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

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

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

See Section 2.7.4C above.

C. Agreement between the Company and the Israel Postal Authority

An agreement dated June 30, 2004 between the Company and the Israel Postal Authority to define and arrange the rights of the Company and the Postal Authority to their joint assets. The agreement listed the joint assets and defined the share each party has in them. It was determined that each of the parties shall have exclusive

rights to their share, except with regard to rights in joint assets, building rights or rights that have been explicitly clarified elsewhere. With regard to a number of additional assets, the party with exclusive rights to them, in whole, will be one party that was so determined.

2.17.3 Various agreements with DBS and its other shareholders

A. Founders' agreement relating to DBS, of December 4, 1998, between the Company, Eurocom Communications Ltd., Lidan Business Enterprises Ltd., and Gilat Communications Ltd., governing the incorporation and management of DBS and the relationship of its shareholders.

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

C. An agreement of November 2001 between the shareholders (with the exception of Gilat Communications Ltd.) and DBS, which amended the dilution formula prescribed in the founders' agreement and determined that the holdings of shareholders be adjusted to their respective investments in DBS so that for the purposes of dilution, the investments (made by way of shareholders' loans) as of the date prescribed in the agreement would bear linkage differentials and cumulative linked interest on an annual basis at a rate of 5.5% per annum from the date of incorporation of DBS.

D. An agreement dated December 30, 2002 between DBS shareholders and DBS determines preference for shareholder loans given as of July 10, 2002 over the loans made prior to that date, and that these loans would bear CPI linkage differentials and annual linked compound interest at a rate of 5.5%, and an amendment to the agreement dated August 6, 2003 which stipulated an interest rate of 11% for new loans granted as of April 27, 2003. Likewise, the agreement relates to the issue of shares and options for shares to shareholders who invest in DBS (for the Company's actions to exercise the options issued to it, see section 1.1.5 above).

2.17.4 Labor agreements

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

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

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

For information in this regard and regarding early retirement, see Note 16 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

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

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

In this regard see also section 2.9.5 above.

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

Following an amendment in July 2000 to the Employment of Employees by Human Resources Contractors (Amendment) Law, 5760-2000, a special collective bargaining agreement was signed between the Company, the Histadrut and the Workers Committee on January 11, 2001 to recruit new employees and stipulate their salary conditions. The agreement applies to new employees and to employees who were previously employed at the Company via human resources companies, in positions listed in the appendix to the agreement (customer service representatives at call centers, administrative workers, typists, warehouse employees, secretaries, mail sorters and distributors etc., administrative employees such as porters, drivers and forklift operators, and others). Under the special collective agreement of December 5, 2006, it was agreed that the Generation 2000 agreement would not apply to such employees as had been recruited into the Company since July 1, 2006. It was also agreed to insert non-substantial amendments into the conditions of employment of employees recruited for employment under the Generation 2000 agreement.

E. Agreement of April 17, 2005 with alternative entity in lieu of the Makefet Fund with respect to early retirement arrangements for employees of the Company

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

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

On February 14, 2008, Harel and the Company signed an amendment to the June 2005 Agreement, the main points of which were: (1) that the June 2005 Agreement would also apply to employees of the Company who resign from their employment at the Company prior to December 31, 2013 under 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 such option. (2) Reduction of the consideration paid by the Company to Harel for every retiree who is insured under the June 2005 Agreement in respect of whom policies have not been issued by Harel on the date of execution of the amendment of the June 2005 Agreement.

In this regard, see Note 16(g) to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

F. Special collective agreement dated December 5, 2006

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

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

market salary model according to their businesses, with a high level of administrative flexibility.

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

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

For the amendment of the agreement being formulated between management of the Company and the employee representation, inter alia with respect to bringing forward the date of implementation of the change in the organizational structure and bringing forward employee retirement dates, see section 2.9.1 above.

2.17.5 Management Agreement

On March 23, 2006, the general meeting of the shareholders of the Company approved entry by the Company into an agreement with a company which is to be owned and controlled by the shareholders of Ap. Sab. Ar. under which the Company shall be given ongoing management and consultancy services, including via directors who may act from time to time in the Company and/or its subsidiaries, all in return for USD 1.2 million each year. The term of the contract is from October 11, 2005 (the date of completion of acquisition of 30% of the shares of the Company by Ap. Sab. Ar.) and until December 31, 2008, unless one of the parties gives notice to the other of its desire to terminate the contract by way of prior notice of three months in advance. On July 29, 2007, a management agreement was executed between the Company and a corporation owned and controlled by the shareholders of Ap. Sab. Ar. Holdings Ltd. This agreement is in force as of October 11, 2005.

2.18 Legal Proceedings

For information on legal proceedings see Notes 15, 16 and 17 to the financial statements for the year ending December 31, 2007, included in this periodic report, and sections 1.1.5 and 2.6.1 above.

2.19 Goals and Business Strategy

2.19.1 Forward-looking information

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

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

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

2.19.2 **Summary of strategy and future plans**

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

Vision and objectives

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

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

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

B. Reducing the decline in revenues from core services;

C. Generating new sources of revenue;

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

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

Business customers

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

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

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

D. Offering a variety of value-added services.

Private customers

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

B. Providing differential pricing tracks;

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

Network

In order to achieve its strategic goals, the Company is using its best endeavors to improve its existing network and to make it comply with its commercial goals, inter alia by laying optical fibers and making investments in the network core.

Organizational restructuring and implementation at the Company

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

2.19.3 **Development trends in Company activities**

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

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

C. The Company is examining the technological viability of distributing digital contents over the Company's network and infrastructure.

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

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

2.19.4 Main projects being planned or currently being implemented

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

2.20 Events or Issues not within the Ordinary Course of Business

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

B. On July 1, 2007, pursuant to the requirements of the Securities Authority, the Company published an immediate report which included details of the steps taken by the Company following the report of the external examiner, Dr. Yoram Danziger, who was appointed by the board of directors as an external examiner to investigate approval of the plan for options to employees and managers, approval of grants to officers and restatement in the financial statements of Pelephone. This report related, inter alia, to adoption of a new working procedure for the board of directors, and the setting up of committees of the board of directors.

On September 4, 2007, after electing the board of directors of the Company, including a number of new members, it was resolved to set up committees of the board of directors, as well as their substance and composition.

For the application regarding a derivative claim and class action relating to this examination see Notes 17(a)(18) and 17(c)(3) to the financial statements of the Company for the year ended December 31, 2007, which are included in this periodic report.

2.21 Risk Factors

A. Increasing competition

Competition in the field of domestic fixed line communications is increasing. Furthermore, the Company views the cellular telephony market as a market which, to a large extent, is an alternative to the fixed-line domestic telephony market.

The companies that are currently in competition with the Company, or that are likely to compete with it in the future, enjoy much greater commercial flexibility than that of the Company, including an ability to cooperate with subsidiaries and affiliates and to market service bundles together with them. Hot's ability to market service bundles ("triple play") with flexibility as to tariffs, compared with the Company's inability to do so, harms the Company's ability to compete.

The number portability that was commenced on December 2, 2007 (see section 2.6.6A above) contributes to increased competition in the industry.

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

B. Government supervision and regulation

The Company is subject to government supervision and regulation that, among other things, relate to licensing for activity, determining permitted areas of activity, determining tariffs, operation, competition, payment of royalties, obligation to provide universal service, ability to

hold its shares, relationships between the Company and its subsidiaries and prohibition to terminate or restrict its services (which may force the Company to provide services even when not economically feasible or when it goes against its interests). Said supervision and regulation at times lead to State intervention, which the Company believes adversely affects is business operations.

C. **Regulation of tariffs**

The Company's tariffs for services are subject to State regulation. These tariffs are stipulated in regulations, and regulations also stipulate a formula for linking them to the changes in the Consumer Price Index, less an amount for depreciation. The practical implication of this mechanism is erosion (in real terms) of the Company's tariffs. Some of the Company's tariffs are subject to the Supervision of Prices for Commodities and Services Law. For the uncertainty regarding the continued update arrangement of the Company's supervised tariffs, see section 2.16.1 above.

D. **Difficulties in labor relations and human resources**

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

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

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

The Antitrust Authority's objection to the merger between the Company and DBS such that the Company's holdings of DBS will increased from approximately 49.8% to approximately 58% (see section 1.1.5(a) above) harms the Company's ability to realize its holdings of DBS.

F. **Legal Proceedings**

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

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

For a description of the legal proceedings, see section 2.18 above, which refers, inter alia, to Note 17 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

G. **Exposure to exchange rate fluctuations and inflation**

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

fluctuations, by converting its liabilities denominated in foreign currency and/or linked to the consumer price index, to shekel-denominated liabilities.

H. Electromagnetic radiation and licensing of broadcast installations

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

The Company is working to obtain permits to build and operate its various broadcasting installation, however, the difficulties it faces in this activity, including difficulties related to the change in policy maintained by the various relevant organizations and amendments to statutes and standards, may negatively impact on the infrastructure of said installations and on the regularity of provision of services using them. The Company's third-party liability policy does not currently cover electromagnetic radiation.

I. Frequent Technological Changes

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

Risk Factor Summary Table

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

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3. Mobile Radio Telephone – Pelephone Communications Ltd. (“Pelephone”)

3.1 General Information on Area of Operations

3.1.1 Pelephone’s field of activity

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

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

3.1.2 Legislative and secondary legislation restrictions applicable to Pelephone

3.1.2.1 General license

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

3.1.2.2 Tariff control

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

3.1.2.3 Royalties

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

3.1.2.4 Environmental matters

The laying and operating of a wireless infrastructure including cellular communications is subject to the provisions of the Non-Ionized Radiation Law and the permits from the Ministry of the Environment that are required in it (see section 3.17 below).

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

The following are financial and quantitative data regarding Pelephone’s scope of operations and profits for 2006-2007:

	2007	2006
Revenues (NIS millions)	4,684	4,478
Operating profit (EBIT) (NIS millions)	805	701
Operating profit before depreciation and amortization (EBITDA) (NIS millions)	1,283	1,171
Number of subscribers at end of period[22] (in thousands)	2,622	2,427
Average minutes of use (MOU)[23] per subscriber per month	354	349
Average monthly revenue per subscriber (NIS) (ARPU)[24]	131	138

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

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

3.1.4 Market development and changes in customer attributes

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

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

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

A. The CDMA track, which developed in the 2.5 generation to 1X and in the third generation to EVDO (hereinafter: "CDMA Technology") – Pelephone's network presently operates using this technology (see section 3.1.5.2 below).

B. The GSM track, which developed in the 2.5 generation to GPRS and in the third generation to UMTS, and in the 3.5 generation to HSPA (hereinafter: "UMTS Technology") – the networks of Pelephone's principal competitors in Israel use this technology and Pelephone also plans to use this technology as from 2009 (see section 3.1.5.3. below).

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

3.1.5.3 On November 1, 2007 the general shareholders' meeting of Pelephone adopted the resolution of Pelephone's Board of Directors from September 2007 regarding establishment of a network using HSPA/UMTS technology at a total investment of NIS 1 billion. Ericsson was chosen as the supplier of the system. The new network is expected to begin operating at the beginning of 2009. The investment in the new network will be spread over 4 years with the main part being invested in 2008 (see section 3.9.1.9). The establishment of the new network will enable Pelephone to provide services requiring the rapid transmission of information, may partly solve the problem of wireless disturbances (see section 3.24.2.5) and will enable use of standard terminal equipment supporting UMTS technology which will permit the expansion of roaming services.

The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration past experience, surveys regarding the industry in which Pelephone operates and its plans for the future. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

3.1.5.4 Pelephone uses frequencies in the range of 850 MHZ in order to operate the CDMA network, and it also has the right to be allocated frequencies in the range of 2100 MHZ (see section 3.10.2 below) which it will use in its UMTS network.

3.1.6 Critical success factors and the changes commencing therein

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

- National deployment of a high-quality, advanced MRT network, ongoing maintenance of the network at a high level and significant investments, on an ongoing basis, in cellular infrastructure, for the purpose of improving high-quality coverage around the country, which is a basic condition for the provision of Pelephone's services, and in order to provide customers with the most advanced services, via the most advanced technological infrastructure.

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

- Provision of high-quality call services and advanced added value services.
- National deployment of service and sale centers which enable high quality customer support and service which allows the Company to successfully deal with a competitive market.
- Professional, high-quality, human resources.
- Marketing strategy for establishing and reinforcing the brand name.

3.1.7 Principal entry and exit barriers

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

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

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

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

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

3.1.8 Substitutes for Pelephone products

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

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

3.1.9 Structure of competition in the sector and changes therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of Bezeq's license and on its behalf[25]). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (hereinafter: "**the second operator"** or **"Cellcom").** In February 1998, a third operator was selected by invitation to tender – namely Partner Communications Ltd. (hereinafter**:** "**the third operator**" or "**Partner**"). As of February 2001, MIRS Communications Ltd., (hereinafter: "**MIRS")** has been operating as an additional cellular operator. After the entry of the second operator, and later, the third operator, into the cellular market, fierce competition developed among the carriers (primarily between the three main carriers). This competition resulted in market saturation expressed in the diminution of the number of subscribers joining the Company, an increase in the transfer of customers between the cellular companies and an erosion in the prices collected by Pelephone from its customers for services rendered by it (see section 3.7 below).

3.2 Products and Services

3.2.1 Services

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

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

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

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

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

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

At present, some 830,000 subscribers have handsets which enable use of third generation services.

Pelephone began supplying added value services at the end of 2002. In 2005, 2006 and 2007, revenues from added value services amounted to 9%, 11% and 13% respectively of revenues from cellular communications (payments for call minutes, fixed subscription fees, added value services and roaming services).

Roaming services – Pelephone provides roaming services (communications via MRT from various locations worldwide), in accordance with agreements that it has with cellular providers around the world. In order to facilitate similar services in Europe and in other countries where the network is not based on CDMA technology (mainly GSM technoloty), Pelephone leases handsets to its customers that are adapted to the technology in use in those countries, in accordance with agreements between Pelephone and cellular operators in those countries. Pelephone has agreements which enable its customers to receive services in 214 countries around the world. During 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets provide an additional solution to roaming services in other countries where the network is not CDMA. In light of the lack of a variety of handsets and support of some of the handsets that Pelephone provides its customers, this solution is a partial solution only and does not address all marketing needs. The establishment of a UMTS network (see section 3.1.5.3. above) will make it possible to increase the variety of handsets and reduce the marketing gap in the area of roaming services.

3.2.1.1 The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration past experience, surveys regarding the industry in which Pelephone operates and its plans for the future. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

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

3.2.2 Products

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

3.3 Segmentation of Profitability from Products and Services

The following are data on Pelephone profitability (in NIS millions):

	2007	2006
	NIS millions	NIS millions
Revenues from cellular services, sale of terminal equipment and terminal equipment services	4,684	4,478
Percentage of gross profit	29%	27%

3.4 New Products

In 2007 Pelephone continued to improve and expand its range of added value services and to increase the number of subscribers who use these services.

3.5 Accounts Receivable

As at the end of 2007, Pelephone had 2.622 million subscribers. Approximately 66% of Pelephone's subscribers are private customers and 34% of Pelephone's subscribers are business customers.

3.6 Marketing, Distribution and Service

Pelephone's distribution system is based on 26 service and sales centers including laboratories spread around the country, which deal in service and sale to customers, treatment of malfunctions, installation of handsets and customer retention. In addition, 12 service and sales centers provide comprehensive service and instead of repairing the handset the customer receives a substitute handset and the handset is sent for repair. The distribution system is strengthened with stores and stands spread over 89 points of sale (some of which are operated by Pelephone employees, and others of which are operated by authorized sellers). In addition, there are various sellers that operate a door to door system, and service and sales representatives for the business sector.

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

3.7 Competition

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

To the best of Pelephone's knowledge from the data published by each of the cellular companies in Israel, as at the end of 2007, there are approximately 8.9 million cellular subscribers in Israel: Pelephone has approximately 2.6 million subscribers, Cellcom reported approximately 3.1 million subscribers, Partner reported approximately 2.8 million subscribers and Mirs, approximately 0.4 million subscribers[26].

3.7.2 Following a Government decision in 2006, the Ministry of Communications engaged the services of an international consultation firm in order to examine the matter of mobile virtual network operators (MVNO) operating in Israel in the cellular market. A MVNO is a cellular operator that purchases airtime from a regular cellular operator (that owns infrastructure)

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

according to a business agreement with it. The virtual operator uses the existing cellular networks and sells its services to the public under a separate brand.

Pelephone has expressed its position that in no case is it justified to use regulatory force on the matter of the MVNO and it even backed its position with consultation work. In addition Pelephone, Cellcom and Partner engaged a joint consultation company, at the approval of the Commissioner of Restrictive Trade Practices, in order to obtain consultation on the matter of competition in the cellular market in Israel and the MVNO. In July 2007 a consultation firm that was engaged by the Ministry of Communications submitted to it the final report. In accordance with the report's recommendations, there is no need at this point for any interference of the Ministry of Communications in this matter. The Ministry of Communications did not schedule a hearing on the matter of the MVNO. Furthermore, in the course of the Government's deliberations on the Arrangements Law, the legislation amendments that were proposed in order to create tools that would grant a virtual operator the right to use the MRT network were removed.

In the framework of the deliberations on the Government's budget for 2008, the Government decided that the Ministry of Communications would prepare to grant MVNO licenses as from December 31, 2007 to anyone who is interested. If such a MVNO license is granted and the owner of such a license holds negotiations with the cellular operators that after 6-9 months do not end successfully and it is proven that the reason is the anti-competitive behavior of the cellular operators, the Minister of Communications shall then consider interfering in the matter of the MVNO entering the market in accordance with the powers granted to him by law.

The Ministry of Communications has not yet granted any license for MVNO activity in Israel.

3.7.3 On March 22, 2005, the joint Finance and Economics Committee of the Knesset approved an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 to the effect that the Minister of Communications is to prepare a numbering plan regarding number portability with respect to a general licensee for provision of MRT services and a licensee for domestic fixed-line communications services, and is to instruct them regarding the implementation and activation of it by September 1, 2006. The licensee is to be required to provide number portability for any subscriber that may request such, and is to do all of the acts required for such purpose without any payment from the subscriber or from any licensee.

Due to the short time schedules provided for the preparations, the cellular operators did not meet the date provided in the Communications Law. Nonetheless, the regulator decided to not postpone the date for implementing the portability plan beyond September 1, 2006. Following this decision, both Pelephone (together with the other cellular companies) and Bezeq filed petitions in the High Court of Justice for a decree nisi against the Government of Israel and the Minister of Communications.

In February 2007 the Ministry of Communications requested from the operators information regarding the status of their preparations for number portability, in light of the Ministry's intention to provide a new time schedule for implementation of the number portability plan.

On May 24, 2007 Pelephone received notice from the Ministry of Communications stating that it was considering imposing a monetary sanction on Pelephone for alleged breach of the obligation to provide number portability as of September 1, 2006. The notice also stated that December 1, 2007 is a reasonable date by which the relevant licensees are required to amend the alleged breach.

In 2007 Pelephone continued to prepare for implementation of the number portability plan and towards December 1, 2007, the date the Ministry of Communications determined to be the reasonable and final date for implementation of the plan, it completed its preparations, including all the necessary tests. In November 2007, after consulting with the Minister of Communications and the CEOs of the communications companies regarding readiness for number portability and the final date of beginning implementation of the plan, Pelephone expressed a position by which the date of implementation should not be postponed beyond December 1, 2007, since Pelephone is prepared and ready to begin the process. At the end of the aforementioned meeting the Minister of Communications decided not to change the implementation date (December 1, 2007).

The number portability process began as scheduled. Pelephone and the other cellular companies that filed the petition requested from the High Court of Justice that it dismiss the petition. As a result of this request the petition was dismissed. As at the date of this report, Pelephone has not been requested to pay any penalties in respect of postponement of the implementation date.

The "Number Portability Program" intensified the already fierce competition between the operators. Such competition gave rise to an increase in marketing campaigns, benefits granted to customers and an erosion of prices. Based on Pelephone's estimates, since the beginning of the "Number Portability Program" and up to the date of this report, about 140,000 subscribers changed companies and the net change in Pelephone's subscribers is about 6,000.

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

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

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

It is noted that Partner and Cellcom, the principal competitors of Pelephone, own such a general domestic and VOB license, and at this stage are operating in the business sector and in the last year have even increased their activity in the area. This constitutes a clear competitive advantage over Pelephone due to the ability of the competitors to offer packages that combine mobile and fixed-line communications.

In September 2007 the Ministry of Communications published a hearing on the policy of allotting frequencies for operating the WiMax technology. In accordance with the proposed policy, new operators and the smallest Israeli cellular operator (Mirs) will be given priority in the allotment. Pelephone has submitted its response to the hearing, by which priority should be granted to fourth generation cellular technology that requires use of WiMax technology frequencies, and has expressed its objection to a tender for the allocation of frequencies that discriminates in favor of MIRS or other operators. The Ministry of Communications has not yet published its policy on the matter.

3.7.5 **<u>Positive and negative factors affecting Pelephone's competitive position</u>**

<u>Positive factors:</u>

A. The advanced third generation cellular network that supports the download of data at a rate of up to 2.4 Mbps, and provides good network quality.

B An advanced product range including DATA solutions for businesses, and a broad spectrum of multimedia and entertainment services.

C. Service system and range of customer service interfaces enabling the provision of high-level service to customers.

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

E. Strong capital structure and positive cash flow.

Negative factors:

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

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

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

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

3.8 Seasonality

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

3.9 Property, Plant & Equipment

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

3.9.1 Infrastructure

3.9.1.1 Pelephone's infrastructure investments

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

3.9.1.2 Pelephone presently operates two communications networks using three technologies:

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

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

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

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

3.9.1.3 As at the date of publication of the report, Pelephone's MRT infrastructure (CDMA) is based primarily on 8 digital switches manufactured by Nortel, connected to approximately 1,500 radio sites (cells), in a countrywide spread. Each radio site incorporates an antenna for reception and transmission and a computerized control system, and covers a certain geographic area. The cells are

connected to base station controls (BSC) that are hooked up to the switches. The switches are connected to one another and to all the other telecommunications operators (Bezeq, Partner, Cellcom, MIRS, HOT, and international operators).

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

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

3.9.1.6 As of 2004, the Pelephone Board of Directors began upgrading the CDMA2000 1XRTT network to EVDO technology by means of the addition of a special–purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the terminal equipment at rates of up to 2,400 KSS (downlink) and between the terminal equipment and the network at rate of up to 144 KSS (uplink). The EVDO equipment is manufactured by Nortel. Parallel to setting up the network, a portal was set up for video services enabling customers to view live broadcast channels, to download music clips, entertainment, news, etc. This portal is the key service using EVDO technology.

3.9.1.7 In 2005, Pelephone acquired equipment from Nortel, in a long-term transaction for 2005-2007, for the expansion of its network, including 150 sites and equipment to upgrade the capacity of the network. The value of the transaction was approximately $ 20 million. This transaction was executed in full.

3.9.1.8 At the end of 2007 a triennial agreement was signed with Nortel by which it would continue to support and upgrade the 1X and EVDO networks for a total consideration of $ 22.5 million.

3.9.1.9 On November 1, 2007 the general shareholders' meeting of Pelephone adopted the resolution of Pelephone's Board of Directors from September 2007 regarding establishment of a network using HSPA/UMTS technology at a total investment of NIS 1 billion. This amount includes the cost of the network supplier, of constructing the new sites required in order to operate in the range of the new frequency, and of converting existing sites and services to UMTS. Ericsson was chosen as the supplier of the system. The new network will be based on two network centers that will be connected to the existing sites and the new sites that are in the process of acquisition/licensing and construction. The existing 1,500 sites will be converted in order to adapt them to the new frequency and be added the new radio equipment. The network will enable higher transfer speeds of information from the subscriber to the network and from the network to the subscriber using HSDPA and HSUPA technology. The establishment of the new network will enable Pelephone to provide services requiring the rapid transmission of information, may partly solve the problem of wireless disturbances (see section 3.24.2.5) and will enable use of standard terminal equipment supporting UMTS technology which will enable the diversification of terminal equipment and the expansion of roaming services.

The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration past experience, surveys regarding the industry in which Pelephone operates and its plans for the future. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

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

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

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

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

3.9.2.3 For the purpose of service and sale operations, Pelephone leases 41 service and sale centers, and 54 points of sale spread out around the country.

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

3.10 Intangible assets

3.10.1 <u>MRT license</u>

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

3.10.2 <u>Frequency usage right</u>

Pelephone uses frequencies in the 850 MHZ range, granted to it by virtue of its license. These frequencies are used by Pelephone mainly for CDMA2000 1XRTT technology and EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2100 MHZ ranges) using UMTS technology. In this regard, see Note 18G to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report. In 2008, there are plans to exercise the right for allocation and use of these frequencies as part of the preparations for establishment of the new network.

The information in this section includes forward-looking information, which is based on Pelephone's assessments that take into consideration its plans and expectations regarding their realization. Actual results may be significantly different than the assessments described above if one of the factors taken into consideration in these assessments changes. See section 3.24 below regarding risk factors.

3.10.3 <u>Trademarks</u>

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

3.10.4 <u>Customer Base</u>

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

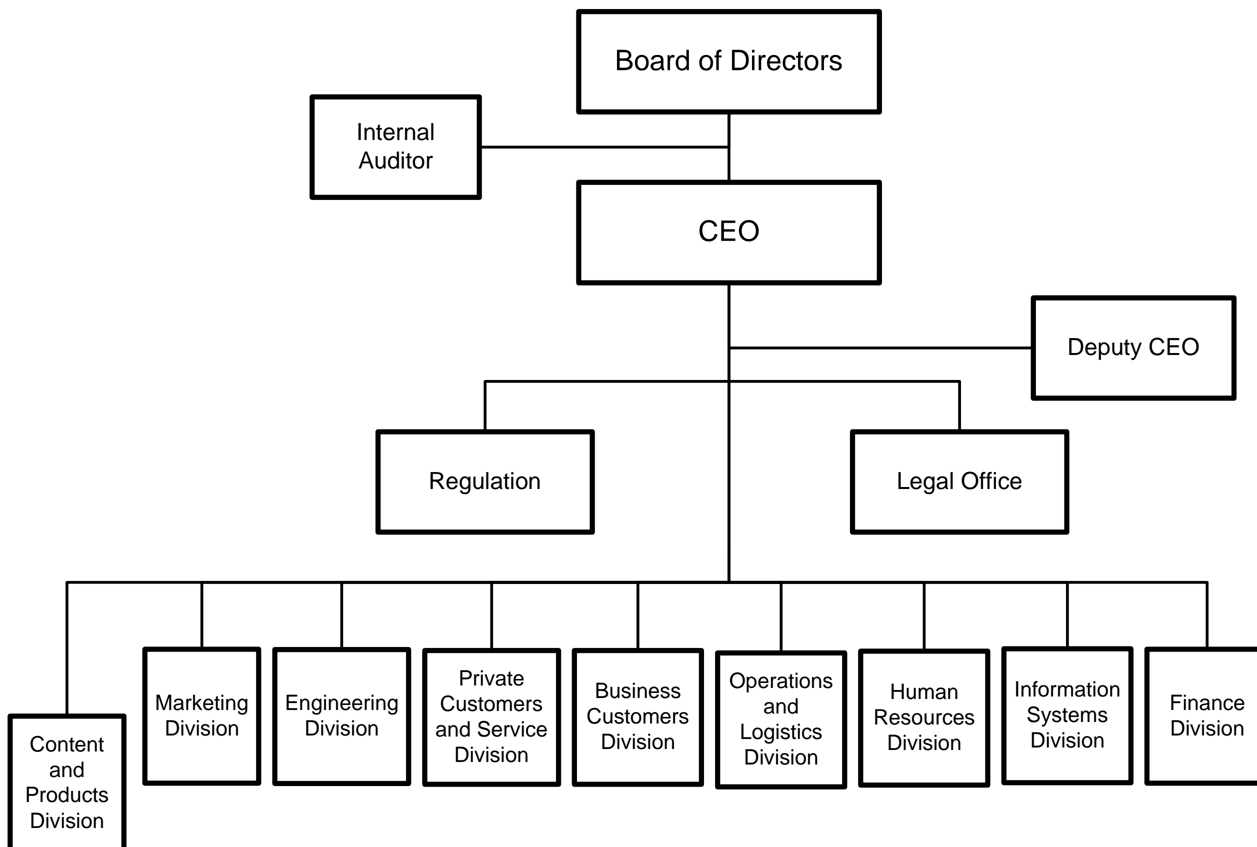
3.10.5 <u>Software, computer systems and databases</u>

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

3.11 Human Resources

3.11.1 Organizational structure

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



3.11.2 Organizational table

The following details the number of employees[27] in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.07	**31.12.06**
Headquarters and management	295	290
Content marketing and products division	102	95
Customer Service and Private Sector Division	2,971	2,427
Business Division	534	438
Operations and Logistics Division	292	306
Engineering and Information Systems Division	617	593
Total	4,811	4,149

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

3.11.3 Changes in the number of employees during 2007

At the end of 2007, Pelephone's manpower stands at approximately 4,811 employees, compared with approximately 4,149 at the end of 2006. The increase is mainly in the service and sales divisions that were strengthened towards the implementation of number portability.

3.11.4 Instruction and training

Pelephone invests resources in professional training in accordance with the type of employee and the field in which he is active. Most training courses take place in the service field, primarily in the service division. Pelephone's total expenses in 2007 and 2006 in respect of instruction and training amount to NIS 10.4 million and NIS 9.3 million, respectively. The employees who work as sales and service representatives and as telephone call center employees have a high churn rate, which requires constant investment in new employees.

3.11.5 Employee and Manager Reward Schemes

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

For the Options' Plan for Senior Officers and Employees of the Company and/or Affiliates – see Note 26 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

3.11.6 Employment contracts

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

3.12 Products and Suppliers

3.12.1 Terminal equipment suppliers

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

Pelephone purchases the terminal equipment and accessories from a variety of suppliers and importers in Israel. Contractual engagements with most of the suppliers are based on framework agreements setting forth, *inter alia,* the technical support provided by the supplier for the terminal equipment it supplies, the availability of the spare parts and the turnaround time for repairs. These agreements do not include a commitment to make acquisitions, which are implemented regularly by means of purchase orders.

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

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

Pelephone is presently preparing for the conversion to UMTS technology, and as a part of these preparations it is acting to expand the number of its principal terminal equipment suppliers and suppliers of data transmission equipment.

3.12.2 Value Added Service Suppliers

Pelephone has agreements with content suppliers under which Pelephone receives content such as information services by voice mail, SMS or via Pelephone's portal, games, animations, ring-tones, location services, content and the rights to broadcast over third generation

technology. As is usual in this industry, a large portion of these agreements are based on a model of dividing revenues between Pelephone and the content suppliers for the services provided to customers. Termination of contracts with certain suppliers might cause delays in supplying some of the services pending contracting with substitute suppliers.

3.12.3 Infrastructure Suppliers

As set out in section 3.9.1 above, Pelephone's present infrastructure equipment is manufactured by Nortel and Motorola. Pelephone has long-term maintenance, support and software upgrade agreements with these suppliers and depends on them with respect to support of the network equipment that they produce. Regarding other agreements with these suppliers and an agreement for the establishment of an additional network see section 3.9.1 above.

3.13 Working capital

3.13.1 Stock holding policy

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

The period over which inventory is held is a consequence of Pelephone's service policy and its sales requirements. The requirements necessitate maintaining an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2007, the inventory level stands at an amount of approximately NIS 169 million.

3.13.2 Returns policy for terminal equipment purchased

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

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

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

3.13.3 Product warranty policy

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

3.13.4 Policy governing credit to customers

Credit in handset sale transactions – Pelephone enables most of its customers purchasing a mobile telephone to spread payments over 36 equal installments. In the past Pelephone's policy was to discount part of the transactions that are paid via credit card installments with discount companies. In 2007 Pelephone stopped discounting credit card vouchers.

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

As at 2007, total average customer credit less doubtful debts amounts to NIS 1,365 million.

3.13.5 Credit from suppliers

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2007, total average credit from suppliers and service providers amounts to NIS 542 million. Investment in Investee Companies and in a Partnership.

3.14 Investment in Investee Companies and in a Partnership

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

3.15 Financing

3.15.1 Pelephone's operations are financed by shareholders' equity, bank loans, debentures, discount of credit cards (see section 3.13.4 above) and supplier credit.

The average interest rate in 2007 for undesignated loans was:

	Long-term loans (including current maturities)
Banking sources: CPI-linked – NIS	4.65
Non-banking sources: CPI-linked – NIS	4.64

3.15.2 **<u>Restrictions</u>**

3.15.2.1 <u>Undertakings towards banks</u>

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

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

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

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

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

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

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

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

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

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

3.15.2.2 Immediate repayment of the loan

A lender may call a loan for immediate repayment in certain instances (usually after serving written warning notice on Pelephone), foremost among such instances being: (A) if any debt to the lender was not paid; (B) if Pelephone adopts a liquidation resolution or if application for liquidation or for the appointment of a liquidator is filed against it or if there is cause for its being liquidated, or for the appointment of a receiver or a trustee; (C) if application is filed for the imposition of an attachment or if an attachment is imposed on the assets of Pelephone or if any execution proceeding is taken against its assets or if it ceases to repay its debts; (D) if Pelephone adopts a resolution in favour of restructuring, merger or settlement or if the control therein is transferred without the lender's consent; (E) if Pelephone ceases to repay its debts or reaches a compromise with its creditors or any of them; (F) if Pelephone is in breach of any undertaking that it has assumed toward the lender or if it should transpire that a material declaration by Pelephone toward the lender is untrue; or (G) if an event should has occurred as a result of which any entity shall have the right to call for immediate repayment of Pelephone's debts towards it (even if such concerns does not make use of its right).

3.15.3 Issue of Debentures

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

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

As at December 31, 2007, Pelephone is in compliance with its commitments to the banks and to the debenture holders.

In 2007, no new long-term loans were taken.

For additional details regarding the composition of the loans and debentures, the conditions thereof and the date of repayment thereof during the report period, see Note 13 of the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

3.15.4 Credit limits

Pelephone's credit limits at banks in Israel amount to approximately NIS 2.03 billion as at December 31, 2007. There are no signed agreements with the banks regarding this sum, but rather, there are oral agreements and non-binding written consents. As at December 31, 2007, Pelephone had utilized NIS 452 million of its credit limit at banks.

3.15.5 Guarantees and charges

See Notes 13 and 19 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

3.15.6 Credit rating

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

On May 1, 2007, Maalot, the company that rates all the series of debentures of the Company, announced that following recent discoveries and the report of the external examiner regarding the writing-off of Pelephone's fixed assets, at this stage no change is expected in the rating of Pelephone's liabilities.

3.15.7 Pelephone's estimate of fundraising in the coming year and sources of financing

Pelephone expects to repay a large portion of its loans during 2008, and it plans additional investments in property, plant and equipment (see section 3.9.1.8 above). If necessary, Pelephone will raise new loans from banking corporations and/or by raising capital on the capital market.

The above information includes forward-looking information that is based on Pelephone's assessments taking into account its plans and the expectation that such will be realized. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.24 below.

3.16 Taxation

See Note 8 to the Company's financial statements for the year ended 2007, which are included in this periodic report.

3.17 Environmental matters

3.17.1 On January 1, 2007 the Non-Ionized Radiation Law – 2006 came into effect. The Non-Ionized Radiation Law replaces the previous legal arrangement regarding non-ionized radiation in the Pharmacists (Radioactive Elements and Products) Regulations 5740-1980 ("the Pharmacists Regulations"). The purpose of the law is to regulate radiation sources and their construction and operation, as well as the provision of radiation measurement service. The law requires obtaining a permit from the commissioner provided in the law for constructing, operating and providing radiation measurement service, other than the construction or operation of a radiation source specified in the Appendix to the law ("additional permit").

The law provides a two-step licensing mechanism, by which the applicant is to first request a permit to construct a radiation source ("**the construction 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 of the Environment in cases or under circumstances determined by him, taking into consideration the type of the radiation source or its location.

As regards the construction permit, the law subjects provision of the permit to performing an assessment of the maximum levels of radiation human beings and the environment are expected to be exposed to from the radiation source once it is operated, including in the event of a malfunction, and to implementing the measures needed in order to limit the levels of exposure of human beings and the environment to the radiation expected from the radiation source once it is operated, including the implementation of technological means that are in use ("**the limiting measures**").

As regards the operation permit, the law subjects provision of the permit to implementation of the limiting measures and to measuring the levels of exposure of human beings and the environment to the radiation created during the operation of the radiation source, with these levels not exceeding the maximum levels of exposure provided by the commissioner in the law. Furthermore, the law also conditions provision of the operation permit on presenting a license according to the **Communications (Telecommunications and Broadcasts) Law 5742-1982** and presenting a license according to the **Planning and Building Law, 5725-1965**, except when a building permit is not required and then the law requires submitting to the local committee a statement in which the applicant specifies the reasons that a building permit is not required for the radiation source. If the engineer of the

local council or the district planner does not object to granting the operation permit within 21 days from the day of submitting the statement, an additional statement shall be submitted by the applicant in which it is stated that the aforementioned period has passed and no objection has been received as aforementioned.

The law includes a punitive section by which, inter alia, the construction or operation of a radiation source without a permit, after having been warned in writing by the commissioner according to the law, is a strict liability offense, in respect of which the punishment for the entity is double the penalty provided in Section 61(a)(4) of the **Penal Law , 5737-1977**.

A small number of city engineers have acted according to the mechanism provided in the law and have provided notice that some access facility or another requires a building permit, and have objected to granting it an operation permit.

The law even indirectly amends the **Planning and Building Law, 5725-1965** and provides that a condition for granting a building permit to a cellular broadcasting facility is the deposit of a deed of indemnity in respect of claims for compensation pursuant to Section 197 of the Planning and Building Law, 5725-1965, providing that such a demand is in accordance with the instructions of the national council. Regarding this matter see section 3.18.3.3 below.

The Non-Ionized Radiation Law includes transitional rules regarding ending of radiation permits granted under the Pharmacists Regulations. During 2007, Pelephone made preparations on the basis of an annual plan to renew all the construction and operation permits of the transmission sites according to the Non-Ionized Radiation Law. Renewal of the permits and receipt of new permits pursuant to the Non-Ionized Radiation Law for all the sites was carried out based on the annual plan such that every month some of the radiation permits were renewed. Recently, there have been delays and difficulties with respect to the handling of the renewal and obtaining the construction and operation permits as required by the Non-Ionized Radiation Law, 2006, and the manner of its implementation by the Supervisor of Radiation in the Ministry of the Environment. In addition, in December 2007, the employees of the Ministry of the Environment commenced sanctions that included, among other things, non-acceptance and/or partial treatment and/or providing short-term permits and/or not handling requests for radiation permits or various requests for permits in respect thereof.

The above-mentioned sanctions delayed somewhat treatment of the requests submitted that month. As at the date of this report, requests for new radiation permits have been submitted with respect to all the transmission sites of the Pelephone network and, except for a very small number of requests that were delayed a bit mainly due to the sanctions, all the radiation permits were renewed, some for short periods owing to the sanctions. Regarding certain types of facilities, new class radiation permits were received in accordance with the Non-Ionized Radiation Law. At the end of January 2008, a full strike broke out in the Radiation Department of the Ministry of the Environment. As a result of the strike, the entire treatment of radiation permits stopped and, in this framework, new requests cannot be submitted in respect of new facilities and/or renewal and/or extension of permits and there is a delay in obtaining permits for facilities the construction of which was already approved. Regarding building permits and access facilities – see also Section 3.18.3.3 below.

If the delays and problems are not resolved within a reasonable period of time and permits are not issued for these facilities, it will be necessary to discontinue transmitting from certain facilities to the extent other solutions are not found.

During the year the Minister of the Environment prepared regulations according to the Non-Ionized Radiation Law ("the Regulations"). These regulations were promulgated and approved by the Interior and Environment Committee of the Knesset and have to be signed also by the Minister of Communications. These regulations have not yet been published. The draft Regulations include instructions that make it difficult to construct wireless access facilities on roofs and roof terraces of apartment buildings (see also section 3.18.1.3. below).

3.17.2 Anticipated costs and investments

Pelephone conducts periodical radiation tests in order to ascertain that it is in compliance with the permitted operating standards and the standards of the International Radiation Protection Agency. These tests are outsourced to companies authorized by the Ministry for the Environment. Pelephone invests on average NIS 4 million per annum in respect of this activity. The Radiation Regulations that have not yet come into effect will require paying fees of insignificant amounts for the provision and renewal of permits required according to the Radiation Law.

3.18 Restrictions on and Regulation of Pelephone's actions

The Minister of the Environment submitted the Non-Ionized Radiation Regulations – 2007 to the Interior and Environment Committee of the Knesset. The regulations were promulgated and approved by the committee but have not yet come into effect. In accordance with the version of the regulations that was approved by the committee, the regulations are expected to have an adverse effect on the construction and operation of broadcasting sites in a number of ways including, inter alia, on the following matters: a significant restriction on the possibility of using access facilities in highly populated areas; more difficulties in obtaining radiation permits for existing and new broadcasting devices and for changes in their operation; a requirement to pay fees on the construction and operation of existing and new broadcasting devices.

Delays and difficulties in the process of renewing construction and operation permits as required by the Non-Ionized Radiation Law – 2006 and its manner of implementation have been recently imposed by the Commissioner of Radiation in the Ministry of the Environment.

If these difficulties and delays are not resolved within a reasonable period of time and permits are not provided for devices, it will be necessary to stop broadcasting at certain devices if no other solutions are found. If this should happen, meeting the figures specified in Section 3.18.1.3. will be negatively affected.

This information includes forward-looking information that is based on Pelephone's assessments. Actual results may be significantly different from the above assessments if there is a change in any of the factors taken into account in making these assessments.

3.18.1 Statutory restrictions

3.18.1.1 Communications Law and licensing obligation thereunder

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

The Law authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms.

3.18.1.2 The Wireless Telegraph Ordinance

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

For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel (inter alia, due to the allocation of a great many frequencies for security uses), by limiting the number of licenses issued for the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of a low range frequency on the other.

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

3.18.1.3 Facilities emitting electromagnetic radiation

On December 20, 2005 the Knesset passed the Non-Ionized Radiation Law 5766-2006, which applies to the use of facilities that emit electromagnetic radiation, and as from January 1, 2007 regulates radiation licensing. See section 3.17 and section 3.18.3.3.

3.18.1.4 The Consumer Protection Law

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

3.18.2 Controlled tariffs

Payments for interconnections:

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

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

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

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

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

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

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

The following table itemizes tariff development:

Date	Domestic interconnect (per minute tariff)	International interconnect (per minute tariff)	SMS
To Sep 2000	62.0	62.0	
From Oct 2000	54.0	25.0	
From Jan 2002	50.0		
From May 2002	50.0		38.0
From Jan 2003	45.0		

Date	Domestic interconnect (per minute tariff)	International interconnect (per minute tariff)	SMS
From May 2004	45.0		28.5
From Mar 2005	32.0		5.0
From Mar 2006	29.69	25.57	2.56
From Mar 2007	26.59		
From Mar 2008	23.27	23.27	2.71

Note: The tariffs are presented in Agorot and do not include VAT. The tariffs as of March 2008 are adjusted for the CPI known in January 2008.

3.18.3 License and site licensing

3.18.3.1 Pelephone's license

The General License for the provision of MRT services granted to Pelephone on February 7, 1996 was for a period of 10 years commencing January 1, 1994, with an option of extending it for additional periods of 6 years each, under the conditions set forth in the license, consisting primarily of compliance with statutory conditions. Following the tender in which Pelephone was allotted third generation frequencies, the license was extended to be valid for 20 years as of September 9, 2002. For the arrangement with the State regarding the right to use frequencies, see Note 18G to the financial statements of the Company for the year ended December 31, 2007 that are included in this periodic report.

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

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

A Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, and in certain instances to even revoke it.

B The license is non-transferable, and neither may 10% or more of any means of control in the licensee be transferred either directly or indirectly, nor may any means of control in the licensee or any portion of any means of control be transferred in any manner in such a way as to confer control in the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.

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

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

E. The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest[28] over

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

another licensee, whether for the payment for the service, whether in the conditions of the service, whether in its availability or otherwise.

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

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

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

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

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

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

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

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

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

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

B. In August 2006, the Ministry of Communications wrote to the cellular companies asking for a response to its intention to amend the companies'

license regarding removal of the connection between an MRT terminal handset purchase transaction and the giving of benefits. Pelephone expressed its objection to the aforesaid license amendment and submitted an economic opinion together with its objection.

On November 27, 2007 the Ministry of Communications published an alternative hearing on the same matter, by which any connection between prices of terminal equipment and airtime, as proposed by the MRT providers, should be cancelled. For example, in accordance with the present hearing it will not be possible to offer plans that include a credit for payments in respect of terminal equipment when a certain use threshold is reached in terms of airtime (debit-credit plans). It is noted that most of Pelphone's present plans are of this type. Pelephone has expressed its objection to the said change. The Ministry of Communications has not yet made a decision on the matter.

C. In April 2007 the Ministry of Communications published its decision regarding amendment of the license with respect to changing the mechanism used for identifying users of erotic services as adults. In accordance with the amendment, the denial of access to receive erotic services will be removed by submitting a request in writing together with a photocopy of an identifying document or by physically appearing before a service representative. The amendment that was supposed to come into effect on May 25, 2007 was delayed for the time being according to a temporary injunction that was issued by the Supreme Court, until the request for the temporary injunction and the petition is heard by a panel of three judges. The temporary injunction was awarded in the framework of a private petition to the High Court of Justice against the aforementioned amendment that was filed in May. The petition includes a request for a temporary injunction suspending the coming into effect of the amendment.

D. On April 17, 2007, the Ministry of Communications sent a hearing document to the cellular operators regarding annulment of the clause in the MRT licenses that allows selling plans with billing segments that differ from 12 seconds. In accordance with the document, Pelephone will be able to sell plans with 12 second billing segments only, and as from January 1, 2009, plans with only 1 second billing segments. In August 2007 the Ministry of Communications made its decision on the hearing, by which as from September 4, 2007 the cellular companies are not allowed to sell plans having billing segments longer than 12 seconds. Furthermore, in its decision the Ministry of Communications referred to the amendment to the license from December 2004 and noted that billing according to segments of 1 second as from January 1, 2009 as provided in the regulations (see also Section 3.18.2 of the periodic report) will apply retroactively also to plans that were sold before this date, contrary to the position of Pelephone.

E. In August 2007 the Economic Committee of the Knesset established a sub-committee for the Economic Committee on the matter of promoting competition in the cellular industry. The sub-committee has chosen to focus on the transparency of the cellular companies' bills.

The committee proposed a number of changes in the present structure of the bill. Furthermore, at the beginning of October 2007 a ministerial committee of the Ministry of Communications was established for the purpose of promoting changes in the bills of the cellular companies in order to increase transparency. The committee is expected to adopt the recommendations of the sub-committee of the Economic Committee and even to recommend additional changes. Pelephone has given its blessing to the plan and is acting to improve its customer bills.

F. In September 2007 the Ministry of Communications published a hearing to the cellular companies in which it is proposed to amend the MRT licenses so that the maximum period of commitment in subscription plans will be limited to 18-24 months. This hearing is based on the recommendations of the consultation firm that examined the issue of virtual operators for the Ministry of Communications and also examined the level of competition in the Israeli

cellular market. According to the recommendations, the accepted period of commitment in the Israeli market is 36 months and it is longer than the accepted period in similar competitive markets in Europe. Pelephone's position was that the shortening of the commitment period should not in any case be implemented retroactively and that the companies should be allowed to offer a range of plans with various commitment periods in addition to plans with no period of commitment. On January 21, 2008 the Ministry of Communications published a secondary hearing regarding the shortening of the commitment period. In this hearing the Ministry proposed an amendment to the MRT license, by which the maximum commitment period in the agreements with subscribers who are not business subscribers shall be shortened to 18 months and the cellular companies shall be obligated to offer, in addition to the plans including a commitment period, reasonable alternatives from an economic point of view that do not include a commitment period. Pelephone has submitted its remarks and as at the date of publication of this report, a final decision has not yet been received from the Ministry of Communications.

G. On January 14, 2008 the Ministry of Communications published a hearing on an amendment to the MRT licenses regarding fixed period transactions. In accordance with the proposed amendment, when an agreement is made with customers who are not business customers regarding the provision of a service or basket of services for a fixed period (in the cellular market this means agreements that include a commitment for a tariff plan, for a service, etc., for a fixed period), the licensee is obligated to notify its customers of the last date of the transaction on each bill sent to the customer, and between one and two months before the end of the transaction to notify the customer also by means of a special letter that specifies the terms that will apply when the fixed period transaction ends. In addition to thus notifying the customer, in every fixed period transaction with a customer who is not a business customer, the licensee is required to give notice in advance of the rates that will apply during the transaction. This means that if the rates are expected to be adjusted during the period of the fixed transaction, the customer should be notified in advance, in the agreement, the exact dates of the adjustments and the exact rates after the adjustments. Pelephone has submitted its comments on the hearing and as at the date of publication of this report, a decision has not yet been made.

3.18.3.2 Royalties

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

3.18.3.3 Site licensing

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

Pelehone erects two mains types of broadcasting sites under two tracks: Macro sites that require a building permit from planning and building councils and wireless access facilities (hereinafter – access facilities) that are exempt from a building permit in accordance with Section 27 of the Communications Law and Section 266C of the Planning and Building Law 5725-1965 (hereinafter – the exemption provision).

The licensing of building cellular broadcasting sites that require building permits is governed by National Outline Plan 36 (hereinafter – NOP 36). The purpose of NOP 36, which came into effect in 2002, is to regulate the spread and manner of setting-up broadcasting facilities, so that the entire country is covered with respect to transmission and reception and the damage to the environment and the landscape is minimal.

The licensing process of NOP 36 requires, inter alia, obtaining a number of approvals from government authorities and regulators, including:

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

B. Approval of the Civil Aviation Administration in some cases.

C. Approval of the IDF.

Various parties have criticized NOP 36, following which a proposal for its amendment was prepared. At the end of 2005 the Government of Israel rejected the proposed amendment to NOP 36 that was prepared by the planning administration of the Ministry of the Interior and requested from a committee of director generals to prepare recommendations on the matter and returned NOP 36 for additional deliberation to the national planning and building council.

In the time that has passed since then and in an indirect amendment to the planning and building law that came into effect upon the issuance of the Non-Ionized Radiation Law on January 1, 2006, it was provided that as a condition for issuing a permit for the construction of a cellular broadcasting facility, a local council shall request to receive a deed of indemnity in respect of claims for compensation in respect of loss of value pursuant to Section 197 of the Planning and Building Law, and that the indemnity will be according to the instructions of the national council, which will be in effect until approval of the national outline plan arranging this matter. On January 3, 2006 the national council decided that the local councils are to request full indemnity (100%) from those requesting such a permit. It was also decided to examine the recommendations of the director generals' committee by a committee of editors that shall present its recommendations regarding the need for changing the NOP and its contents. As at the date of this update, Pelephone has deposited with various local councils 170 deeds of indemnity in accordance with the law.

On December 4, 2007 the national council discussed the matter and decided to transfer a new version of NOP 36 to the district councils for comments and public objections. This new version, if it should pass all the necessary proceedings and come into effect, shall replace the present NOP 36. The new version is more strict and demanding than the present NOP 36 and it is expected to delay, complicate and make it more difficult to obtain building licenses for cellular sites under this track. The aforementioned amendment of NOP 36 is subject to the approval of the national planning and building council and the Government of Israel.

Allegations were raised against the present NOP 36 by which it does not arrange the matter of providing permits to facilities that operate under certain frequencies called "third generation frequencies" that are not included in the list of frequencies attached to NOP 36. The competitors of Pelephone have a large number of sites that broadcast under third generation frequencies and have received building permits according to NOP 36. Pelephone disagrees with these allegations and intends to use the third generation frequencies it acquired from the Ministry of Communications like its competitors. The proposed new version of NOP 36 includes a clarification to this matter.

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

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

adversely affect the existing infrastructure, the network's performances and the setting-up of any additional cellular sites required by the network.

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

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the IDF, even though the applications for the approvals have long since been submitted to them. Similarly, administrative or other delays occur in some planning and building councils in the issue of building permits for sites. Therefore, Pelephone operates a number of broadcasting sites that have not yet received building permits. Applications for the building permits have been submitted by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

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

As at the date of this report, Pelephone has succeeded in most of the above mentioned cases to avoid demolition or delay the execution of demolition orders pursuant to arrangements it reached with the planning and building authorities in order to resolve the matter of the deficient licensing. These arrangements have not necessitated any admission of guilt by officers of Pelephone and/or their conviction. However, it is not certain that this state of affairs will continue in the future, or that there will be no further instances in which demolition orders are issued and indictments are filed in respect of building permits, including against officers.

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

The second track under which Pelephone erects broadcasting sites is the access facilities track. The access facilities 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.

Various local authorities have disputed the applicability of the exemption provision to access facilities of a cellular network and to its use. The position of Pelephone regarding the applicability of the exemption was accepted in a number of rulings and decisions of local affairs courts and the use of such facilities and the supporting equipment in them was approved. One verdict in the same instance provided an opposite ruling. Appeals were submitted in respect of some of these decisions and rulings which are pending before the District Court. A petition was submitted to the High Court of Justice against the legality of using the exemption provision for cellular network access facilities, which was dismissed because of threshold conditions. In this framework the State Attorney announced that the Attorney General is preparing his opinion on this matter and is holding staff work between the relevant government offices. As at the date of this report the Attorney General has not yet provided his opinion on the matter.

Pelephone uses access facilities in order to provide coverage and capacity to highly populated areas. Reducing or preventing use of the access facilities track in a given geographical area may have an adverse effect on service in that area until substitute broadcasting sites can be built. As at the date of this report, Pelephone operates 274 wireless access facilities.

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

antennas are similar to emissions from cellular terminal equipment. These relays and others have received a class approval from the Ministry of Communications.

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

A number of local authorities have recently presented to the Commissioner of Radiation in the Ministry of the Environment their objection to the construction of access facilities, on the basis of a clause in the Non-Ionized Radiation Law that conditions the provision of operation permits for access facilities on the approval of the relevant authority. Additional authorities are anticipated to join this objection. As a result of these objections the Ministry of the Environment is refusing to issue operation permits to access facilities that were erected according to the law in these authorities.

Meetings were held in the last month in the Interior and Environment Committee of the Knesset regarding regulations for the Non-Ionized Radiation Law. The regulations provide a set of rules for the erection of sites, such as safety distances, location of the sites, etc. After the committee completes its deliberations and the regulations are approved, the Minister of the Environment and the Minister of Communications are to sign the regulations as final approval. On the matter of access facilities, courts of local affairs recently handed down two additional rulings which recognized the legality of erecting wireless access facilities of cellular networks.

3.18.4 Antitrust

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

3.18.5 Standards

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

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

The approval is in force until October 12, 2010.

ISO 9001 2000 edition consists of a series of standards for quality management in the services. This is a standard for quality control systems that defines requisite conditions for compliance with service process standards and also constant improvement and testing of the effectiveness of the quality management system and its components.

Pelephone carried out the required adjustment for obtaining the approval in line with the tendency of the business-industrial world in general and the tendency of its customers in particular, to contract exclusively with suppliers meeting the requirements of the Standard.

3.19 Substantial agreements

For undertakings to banks, see section 3.15.2 above.

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

3.20 Joint venture agreements

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

For roaming agreements see section 3.2.1 above.

3.21 Legal proceedings

For legal proceedings, see Note 17 of the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

3.22 Goals and Business Strategy

Pelephone's principal strategic goals are:

1. Increase revenues and improve profitability;
2. Lead with third generation;
3. Launch an additional UMTS network.
4. Increase its market share in the long term.

In order to achieve its goals, Pelephone operates on a number of principal levels:

1. Increasing customer satisfaction

   Pelephone acts to increase its customers' satisfaction and to strengthen their loyalty to Pelephone's services. These actions are expressed in improvement of the service system, terminal equipment upgrading offers, and the grant of benefits to Pelephone's customers under a marketing package which reinforces the Pelephone-customer relationship. Pelephone uses an advanced measurement system in order to monitor the satisfaction of its customers so that it may learn from it and constantly make improvements.

2. Third generation lead

   Pelephone has set itself a goal of being a third generation leader. In 2007 Pelephone has reached leadership in this area and it presently has the largest number of subscribers with third generation handsets compared to its competitors. This leadership is expressed by an increase in revenue from third generation services and by the number of subscribers who join such services.

   This leadership will be preserved by continuing the following actions:

   A. Launching a broad range of third generation handsets.

   B. Setting up a communications structure to cover all content.

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

3. Continued investment in infrastructure

   Pelephone is in the process of setting up another cellular network using UMTS technology (see section 3.1.5.3 above).

   The above information includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.24 below.

3.23 Development outlook for the coming year

During 2008, a number of factors are expected to affect Pelephone's activities, the principal ones are as follows:

3.23.1 Continued reduction of interconnectivity fees

As set out in section 3.18.2 above, on March 1, 2008, interconnect fees will drop by another 4 Agorot. This reduction might harm Pelephone's revenues.

3.23.2 Third generation services

Pelephone expects that during 2008, it will increase the amount of customers that use third generation services, it will increase its range of such services and as a result, Pelephone will continue to increase its revenues in this field.

3.23.3 Innovative added value services

In 2008, Pelephone is expected to continue to improve its existing services and to widen its range of advanced added value services that will help improve the perception of the brand and increase revenues from existing customers.

3.23.4 Number Portability

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

3.23.5 Set-up of another cellular network

During the course of 2008, Pelephone's intends to set up an additional cellular network using UMTS technology (see section 3.1.5.3 above).

The information in this section includes forward-looking information, which is based on Pelephone's assessments taking into account past experience, surveys regarding the state of the industry in which Pelephone operates, and its own future plans. Actual results might be substantially different from the assessments set out above, if there is any change in any of the factors taken into account in making these assessments. For risk factors, see section 3.24 below.

3.24 Discussion of Risk Factors

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

3.24.1 Macro-economic risk factors

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

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

3.24.2 Industry-based risk factors

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

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

3.24.2.3 Regulatory developments – In the area of Pelephone's operations, there is a trend to legislate and impose standards on issues such as the environment, increased competition, tariffs, product liability and the methods used for repairing

products, etc. These regulations might, inter alia, make it much more difficult to construct cellular sites, so as to impair network quality, increase the costs of services and marketing, and due to the strong competition it might not be possible to roll those costs in full onto consumers, as a result of which, profits in the industry might be eroded. Furthermore, regulatory interference and the uncertainty it entails may have an adverse effect on the ability of the Company to plan its business conduct.

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

3.24.2.5 Electromagnetic radiation – Pelephone operates hundreds of transmission facilities and sells terminal equipment that emit electromagnetic radiation (see Section 3.18.1.3 above). Pelephone is taking steps to ensure that the levels of radiation emitted by the aforementioned transmission facilities and terminal equipment do not exceed the levels of radiation permitted in the directives of the Ministry of Environment (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, which constitutes a risk to health, the effect could be negative following a reduction in the use of the Company's services, difficulty in renting sites, claims for bodily and property damages of 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 Building Law. Pelephone's third party liability insurance policies do not presently cover liability for electromagnetic radiation.

3.24.2.6 Site licensing – The erection and operation of cellular antennas are subject to building permits from the various planning and building committees, a process that involves, inter alia, obtaining a number of approvals from Government entities and regulatory bodies. For details of the difficulties encountered by Pelephone in the erection and licensing of sites, see Section 3.18.3.3 above. These difficulties may impair the quality of the existing network and even more the deployment of the new network.

3.24.3 <u>Pelephone's Risk Factors:</u>

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

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

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

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

3.24.3.5 Legal proceedings – Pelephone is party to legal proceedings, including class actions, which are liable to result in its being ordered to pay material amounts that cannot presently be estimated, and in respect of most of which no provision has been made in Pelephone's financial statements. Pelephone is exposed to class actions. Class actions may reach high amounts, since approximately one third of the residents of the State of Israel are Pelephone consumers, and a claim relating to a small amount

of damage to a single consumer may grow into a material claim against Pelephone if recognized as a class action applicable to all or a large proportion of those consumers for legal proceedings to which Pelephone is a party.

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

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

Effect of Risk Factor on all of Pelephone's Activity

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

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

4. International communications and internet services – Bezeq International Ltd. (Bezeq International)

4.1 General

4.1.1 Structure and changes to area of operations

Bezeq International, a wholly owned Bezeq subsidiary company, supplies direct dialing telephone services to 240 destinations all over the world. Bezeq International's telephone services, similar to services of other international operators competing in the market, are primarily based on the Company's domestic network and on the cellular network for connecting the subscriber to the international exchange.

In addition to international call services ("Voice Services"), Bezeq International supplies data communication services (" Data Services"), ISP ("Internet Services"), value added services, telephony routing services between foreign international communication operators and server and web hosting services ("Hosting Services"), and integration services offering Bezeq International's business customers comprehensive communication solutions, including data services, web and server hosting, and maintenance services and technical support for networks ("Integration Services").

Bezeq International's data communication services include: point to point (P2P) lines, frame relay, virtual private networks, ATM, ISDN, video conferencing facilities and IP services.

In addition to the services specified in this chapter of the periodic report, since its full merger with BezeqCall Communications Ltd. ("BezeqCall") on 11 February 2007("the Date of the Full Merger"), Bezeq International has been providing network end point services ("NEP Services"), including data communications infrastructure services, passive infrastructure installation services and low voltage systems, sale of exchange systems including IP telephony communications systems, and providing installation and maintenance services for these systems.

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The communications market in Israel is primarily regulated by the Communications Law (Communication and Broadcasting) 5742-1982 ("the Communications Law") (see section 4.17 below).

4.1.2.1 General license

Bezeq International operates in compliance with a general license for supply of Bezeq's international services (in this chapter:" the License"), which is valid until 2022. The provisions of the license regulate, inter alia, the method for determining tariffs charged by Bezeq International for its services, their update and collecting the payments for these services.

On 11 July 2007, the Ministerial Committee approved an amendment to the Communications (Telecommunications and Broadcasting) Law 5742-1982, which is parallel to the Limitation of Access to Adult Internet Sites Bill 5766-2006, of Knesset Member Amnon Cohen, and submitted it to the Economic Committee of the Knesset. The bill, which was discussed by the Economics Committee, propose restricting access to sites that contain pornographic content, gambling, or violence, inter alia by imposing an obligation on internet service providers, including Bezeq International, to activate mechanisms that oversee access to such sites. Due to the many questions raised in the Committee relating to the constitutionality of the amendment, as well as to the technical aspects involved in its implementation, the Committee requested that the Ministry of Communications present it with data before it makes any decision in this regard. At this stage, before the bill is passed in the first reading and submitted to the Economic Committee of the Knesset, and it is not possible to assess the implications of this law, if and when it is passed, on the commercial operations of Bezeq International.

4.1.2.2 Application for a special domestic operator license

On 16 May 2006, Bezeq International applied to the Ministry of Communications for a general special license to operate Bezeq domestic fixed-line services. Under this license, Bezeq International will provide, inter alia, domestic VOB services (which are an integral part of the product mix of internet providers), and will allow

Bezeq International to continue to provide its customers comprehensive communication solutions (similar to those offered by its competitors, some of which have already received similar licenses) and to compete as equals.

4.1.2.3 Special marketing trial license to provide VOB services

On 6 December 2004, the Ministry of Communications granted Bezeq International a special license to conduct a marketing trial of domestic telephony services using Voice Over Broadband (VOB) technology The trial allowed Bezeq International to provide full VOB services, for payment, to a maximum of 8,500 lines. The trial license was initially granted for one year, and was extended from time to time, with the last extension valid to 28 February 2007. Following the petition for an interim injunction submitted by Bezeq International against the Minister of Communications, set forth in section 4.19.4 below, on 27 February 2007, the Ministry of Communications notified Bezeq International of the extension of the validity of the marketing trial until the ruling on this injunction.

On 5 September 2007, the Supreme Court ruled to dismiss the petition and allowed the Ministry of Communications' decision to stand . In view of the Supreme Court judgment, the Ministry of Communications instructed Bezeq International to cease the supply of services to its customers and end the trial by 15 October 2007, the date for disconnecting all trial customers.

Under the decision of the Ministry of Communications, Bezeq International shall not be eligible for a permanent domestic operators license until the Company's market share falls below 85%.

4.1.2.4 Royalties

Under its license and the Telecommunications (Royalties) Regulations 5761-2001, Bezeq International pays the State of Israel royalties of 3.5% per year, out of most of its revenues from supply of international call services and P2P lines, less permitted expenses and with the exception of revenues from customers determined in these regulations.

In the past, Bezeq International carried out an examination, which uncovered that the calculation method for royalties due by Bezeq International is incorrect and that it paid excessive royalties in previous years. Accordingly, Bezeq International updated payment of the royalties it transferred. On the publication date of the periodic report, there is a dispute between Bezeq International and the Ministry of Communications in respect of this update.

In the matter of the percentage of the royalties, in August 2006 the Ministry of Communications and the Ministry of Finances approved the Telecommunications (Royalties) (Amendment) Regulations 5766-2006 so that the royalty rate was reduced from 3.5% to 3%, as of January 2006. The amendment also determined that the royalty rate would be gradually reduced, so that in 2007 the rate would be 2.5%, in 2008 it would be 2%, in 2009 it would be 1.5%, and from 1 January 2010 it would be 1%. In this regard see also section 2.16.3 above.

4.1.2.5 NEP license

On 31 December 2006, the Ministry of Communications approved transfer of BezeqCall's NEP license to Bezeq International. As of the date of the full merger, Bezeq International has been providing NEP services under this license.

4.1.3 Main entry and exit barriers

4.1.3.1 The main entry barrier in the international call market is the need for a license under the Communications Law and investments in infrastructure, which are affected by frequent technological changes. However, change 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.

4.1.3.2 The main entry barrier into the data and internet services market stems from investments in infrastructure (international capacity, access to the internet network and broad service network).

4.1.3.3 The main exit barriers for these markets stem from long-term agreements with infrastructure suppliers and from investments that require a long time to return.

Furthermore, Bezeq International is committed to provide service to its customers for the period of engagement with them.

4.1.4 Substitutes for Bezeq International products

Some service providers in the international call market do not have a license (illegal operators) and therefore do not bear the restrictions imposed on Bezeq International by virtue of the license and the provisions of the law. Furthermore, 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 and services of communication providers abroad. 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.

4.1.5 Structure of competition in the sector and changes therein

4.1.5.1 In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. In July 1997, two other international operators entered the market: Barak I.T.C. (1995) – International Telecommunications Services Company Ltd., and 012 Golden Lines Ltd. This led to a sharp fall in the prices of international calls and extensive growth in market volume. In April 2004, the Communications (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services) Regulations 5764-2004, came into effect. On the publication date of this report, the Ministry of Communications has granted general licenses to provide international telecommunications services to three more operators: Internet Gold-Kavei Zahav Ltd. (Internet Zahav), Netvision Ltd., and Xfone Communication Ltd., all of which started operations by the end of 2004. The expansion of competition led to an additional fall in the prices of international calls, although, unlike 1997 when competition began, the volume of international traffic did not undergo a significant increase, since prior to the expansion of competition, call prices did not constitute a factor preventing the public from using the service. The above-mentioned expansion of competition had a negative effect on the results of Bezeq International's operation and on its financial condition, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector.

4.1.5.2 Following the mergers, as of the end of 2007, the consolidated company Netvision Barak 013 operates with one international dialing code. This was also the intention for Smile 012 – the Ministry of Communications allowed continued use of the dialing code 015 until the end of 2008 – meaning one company has two international dialing codes.

4.1.5.3 As at the date of the periodic report, licenses for providing internet services have been granted to some 70 companies, among them five of the aforementioned international operator licensees.

4.1.5.4 In December 2004, the Ministry of Communications permitted Bezeq International to provide fixed line telephony services over its internet network (VoIP) to 8,500 customers for a trial period of one year (which was extended to the end of August 2006).

On 20 April 2005, the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the license for providing telephony services by broadband access (VOB), in a way that will prevent Bezeq International from providing the service until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and 2007. This policy amendment, if adopted, is liable to remove Bezeq International from this developing market. This will award its competitors in internet access and international dialing services (most of which have received marketing trial licenses from the Ministry of Communications for providing these services and some are already operating in accordance with it) a clear competitive advantage in that they will be able to offer their customers a total communications solution combining internet access and international telephony and fixed-line domestic

telephony services. On 7 February 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims regarding the introduction of the aforementioned policy amendment. Following the hearing, on 8 February 2006, the Ministry of Communications published a notice of its intention to ease the limitation on Bezeq International and to permit it to act in VOB, under certain restrictive conditions.

On 31 January 2007, the Minister of Communications decided to amend the policy of the Ministry of Communications regarding the licensing of VOB services, pursuant to which Bezeq International would only be granted a license to operate domestic land-line telephony services using VOB technology once the Company's share of the market for domestic land-line telephony dropped below 85%. Following that decision, the Ministry of Communications granted 012 Golden Lines Ltd. a permanent license to provide VOB services as part of its special domestic license, and gave notice of its intention to grant similar licenses to other licensees. On 5 February 2007, Bezeq International petitioned the Supreme Court, sitting as the High Court of Justice, to revoke the Minister's decision, as set out in section 4.19.4 below.

On October 15, 2007, following the judgment of the High Court of Justice, the Ministry of Communications revoked the Bezeq International's license for trials in the field.

The inability of Bezeq International to offer a similar total solution could cause the departure of existing customers in favor of the services of competitors and could present difficulties in attracting new customers. At this stage, Bezeq International is unable to estimate the effects of expected churn on the results of its operations and on its financial situation. In this regard see also section 2.6.1 above.

4.1.5.5 Implementation of the numbering plan and number portability could also affect the difficulty of Bezeq International to provide a solution for the needs of its customers, which include ISP and domestic operator packages.

Furthermore, implementation of the numbering plan and number portability (see section 2.6.6 above) could require Bezeq International to make additional investments in infrastructure and equipment.

4.2 Products and services

Below are details of the principal products and services provided by Bezeq International.

4.2.1 Voice services

In the voice services sector, Bezeq International provides international direct dialing (IDD) services to business and private customers; toll-free number services for business customers overseas; telephone card services enabling prepaid and postpaid dialing, mainly from overseas to Israel, for business and private customers; and the 1809 service for dialing from Israel to other countries by dialing 1809. In this regard, see also section 2.6.1 above.

4.2.2 Internet services

In the internet services sector, Bezeq International provides internet access services for private and business customers, including terminal equipment and support, with an emphasis on fast broadband internet based on ADSL or cable infrastructures; hosting services – site storage and server services in a designated installation for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' internet and LAN connections using the required terminal equipment or software, including monitoring; data services with international data communication IP solutions for business customers, including global deployment if necessary; and wireless (WIFI) access – fast wireless access solutions for private and business customers, including in various public locations (hotspots).

4.2.3 International data services

Supply of international data communication solutions for business customers, including customized global deployment.

The customer is able to choose from a range of advanced data communication methods:

- DIA is a reliable and scalable P2P public IP platform manufactured by BT Infonet. The service allows global internet access (ISP) through one internet provider, and is designed as an optimum solution for the current requirements in business VPN connectivity.
- iWorks is a global offnet internet service that complements DIA, supplied as a one-stop-shop service through Bezeq International. The service provides full connectivity to public internet, through local providers in each country.
- IP VPN secure service enables transfer of multi applications on a consolidated network, including data applications, real time, and mission critical.
- Bezeq International supplies a range of private P2P services through optic cables running from Israel to Europe, for which the Company has long-term leasing rights.

4.2.4 <u>PBX services</u>

Following the merger with BezeqCall, Bezeq International markets and maintains communication systems in the Israeli market, exchanges, telephony networks and IP communications. As part of the service contracts, Bezeq International supplies direct maintenance of a range of exchange manufacturers. The services are given to gateways, exchanges and network end points (NEP) designated for use with both internal and external lines.

4.2.5 <u>Integration services</u>

In the third quarter of 2005, Bezeq International set up an integration and new business division that will focus on data, server and website hosting, and total integration solutions for businesses.

4.2.6 In the NEP services sector, Bezeq International provides sale, installation, and maintenance of exchange systems; installation and maintenance of data communications infrastructure; installation and maintenance services for passive infrastructure and low-voltage systems, with emphasis on integrative solutions tailored to business and institutional customers on their premises.

4.3 Revenues

Below are data of Bezeq International's revenues (in NIS millions):

	2007	2006	2005
Total revenues	1,304	1,022	815
Gross profit (%)	34%	35%	35%

4.4 New products

Following are descriptions of the principal new products launched in 2007:

4.4.1 **Disk-online service** – network backup/storage solutions for private customers for 1, 5, and 10 G volumes

4.4.2 **Heritage service** – screening of network content, designated for the religious community

4.4.3 **Virtual domain server (VDS)** – offering a virtual server stored and managed at Bezeq International (and not at the customer's premises), with a configuration for a number of virtual server environments on one physical server

4.4.4 **eToken** – authentication systems for end users for secure access of employees/external suppliers to the organization; a solution for customers in all segments

4.4.5 **SSL VPN** – secure access systems for organizational applications of the organization's external users; a solution for customers in all segments

4.4.6 **Applicure** –firewall for application security of websites for server farm customers and onsite solutions

4.4.7 **VMWARE** – virtualization solutions for merging servers for business customers at the customer's premises.

4.4.8 **Pointsec** – Check Point endpoint security systems (computers and laptops) for business organizations.

4.4.9 **F5** – application delivery systems, a solution for balancing loads and accelerating applications for websites and server farms; designated for strategic customers

4.4.10 **EMC** – from leading storage solutions manufacturers, designated mainly for the enterprise market

4.4.11 **Beyond Security** – automatic scanning system for vulnerability assessment of information security for customers

4.4.12 From the date of the full merger, Bezeq International absorbed all the products and services that BezeqCall sold and supplied at that time. In this matter see update to section 4.2 above: Products and services.

4.5 Marketing, distribution and service

4.5.1 The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International, which are used by Bezeq International to remain in contact with the advertising media (television, internet, radio and the daily national press), production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies. Bezeq International believes that the loss of contact with any of its permanent advertising or marketing suppliers will have no significant effect on its marketing and distribution channels.

4.5.2 Bezeq International operates sales channels for the private market, as set out below:

4.5.2.1 Recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files

4.5.2.2 Retention center for internet and incoming voice call services providing solutions for customers wishing to leave Bezeq International, and retention center for internet and outgoing voice call services which handles existing customers proactively

4.5.2.3 National direct sales setup conducting door to door operations, operating points of sale and managing customers

4.5.2.4 Distribution channel setup including external centers and field systems for resellers and dealers

4.5.2.5 Yes@wow – a joint venture with DBS in which subscribers are recruited for integrated packages comprising internet access, multi-channel television, and company internet access infrastructure (for further details see also section 5.16 below)

4.5.3 Bezeq International operates sales channels for the business market, as set out below:

4.5.3.1 New customer recruitment center – for SMB customers under the ingoing and outgoing call model, using files

4.5.3.2 Increased existing customer volume center – for SMB customers under the ingoing and outgoing call model, using files

4.5.3.3 Customer portfolio retention center which handles the "heaviest" customers in the SMB sector, retains them and increases revenues from them. This center also acts as a second line regarding retention matters

4.5.3.4 National direct sales setup conducting door to door operations, operating distributors and recruiting SMB customers

4.5.3.5 A telemeeting center for setting and coordinating meetings with potential customers for SMB and SME customers

4.5.3.6 SME sector which concentrates customer managers who recruit and manage medium-sized customers on an ongoing basis

4.5.3.7 ENT sector which concentrates customer managers who recruit and manage strategic customers on an ongoing basis

4.6 Competition

The main characteristic of market competition is market consolidation, which includes the mergers of Barak - Netvision, Golden Lines - Internet Zahav, and on the other hand, the merger of Bezeq International with BezeqCall.

The domestic carrier is a new issue with customers and will allow for the drafting of agreements with customers with respect to connections to the internet and international calls.

The competition is characterized by eroding tariffs.

4.6.1 Voice services

4.6.1.1 At the end of 2007 there were four competitors operating in the market: 014 Bezeq International, Netvision 013 Barak, 012 Smile (still operating with two dialing codes – 012 and 015), and 018 Xfone

In Bezeq International's estimation, its market share in the outgoing calls sector is 36%.

4.6.1.2 General characteristics of competition in 2007

4.6.1.2.1 About 50% of households make international calls at least once a month.

4.6.1.2.2 The various sectors are extremely important (emphasis on immigrants originating from the former USSR) and marketing operations are designed accordingly.

4.6.1.2.3 The product is a commodity.

4.6.1.2.4 The market is a price market.

4.6.1.2.5 There is low consumer involvement due to the low costs.

4.6.1.2.6 Fierce competition and penetration of VoIP technology increase competition for customers.

4.6.2 Internet services

This market has three competitors after the mergers: 014 Bezeq International has a market share of 36% and Netvision-Barak and Internet Zahav-Golden Lines share the remainder of the market.

4.6.2.1 General characteristics of competition in 2007

4.6.2.1.1 Some 72% of Israeli households are connected to the internet, and 95% of these have high-speed connections.

4.6.2.1.2 There are two alternatives for customers in the market: ADSL, the leading Bezeq infrastructure and HOT infrastructure

4.6.2.1.3 HOT frequently cooperates with Bezeq International's direct competitors and acts to restrict Bezeq International's internet operations, for example the Mega-7 bundle. After Bezeq International's petition to the court, HOT was required to terminate its exclusive cooperation with the competitors, until it acts equally with Bezeq International.

4.6.2.2 Main developments in 2007

4.6.2.2.1 Continued slowdown in the growth rate of high-speed internet compared with previous years

4.6.2.2.2 Launch of high speed services by infrastructure companies (4, 7, 8, 10 Mb)

4.6.2.2.3 Continued transition of customers to higher speeds

4.6.2.2.4 Purchase of value added services

4.6.2.2.5 Continued importance of price for the customer, and, in view of the market saturation, emphasis on nurturing customer loyalty

4.6.2.2.6 Strengthening sales of bundle and triple packages in the market, meaning infrastructure suppliers affect market behavior

4.6.3 <u>Solutions for the business sector – Bezeq International business</u>

<u>Characteristics of the business sector in 2007</u>

From the aspect of customer orientation and with the aim of increasing revenues from business customers, Bezeq International started supplying integration services to businesses in 2007, providing full solutions in areas such as system, networking, IT, hosting, voice, data, ISP and wireless.

There is a full solution model for the customer, without relying on external suppliers, and the customer has one contact person with responsibility for the process (One supplier, one responsibility).

With the introduction of integration solutions, Bezeq International is facing new competitors in this field, such as Binat, Taldor, and IBM.

The rest of the companies that are in competition with Bezeq International, and which, as well as the Bezeq Group, fall into two main communications groups, are also trying to reinforce this field and competition is expected from that direction as well. The expectation is that Internet Zahav will reinforce its integration solutions in the merged company, and that Netvision will also continue to do so.

<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, Telrad, GlobeCall, Gil International and Tel-Yad.

The data communications and IP telephony field is characterized by the entry of new players – IT companies – into the world of voice. These are companies such as Binat, Teldor, Netcom, 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 total communications solutions, such as telephony, transmission, data communications, internet, and information security.

4.7 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:

4.7.1 Voice services for the business sector – decrease in August and during the Passover / Tabernacle holidays.

4.7.2 Voice services for the private sector – increase in the summer months and towards the end of the civil year

4.7.3 Internet services – best results usually obtained in the fourth quarter

4.7.4 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 in the summer vacation months).

4.8 Property plant & equipment

4.8.1 In the periodic report for 2005, Bezeq International referred to international communications infrastructure (underwater cables and international switches) which the Company leases (mainly from Mediterranean Nautilus Limited) as plant and equipment. Upon adoption of IFRS, Bezeq International's rights in international infrastructure can no longer be regarded as plant and equipment. For reference to Bezeq International's contract with the infrastructure supplier Mediterranean Nautilus, see section 4.11.5 below.

4.8.2 Towards the end of 2004, Bezeq International signed an agreement with Veraz to purchase SoftSwitch switches which, during the course of 2005, replaced the Alcatel S-12 voice switches (which, at this stage, are still being used as a non-substantial component in the Company's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an intelligent network (IN), which was also replaced in 2005 as part of the upgrade of its voice setup.

Bezeq International's technological infrastructures, which support voice, data and internet setups, are deployed in four sites to provide services with high survivability. In 2005, Bezeq International set up another site in London, England, through which advanced services are provided to its customers.

Bezeq International has long-term lease agreements for the two main structures in which it is based, for average periods of 6 years.

4.8.3 On 14 November 2006, Bezeq International signed an agreement with Avnet Choshen Building and Investment Company Ltd. to lease 7,000 sq. m for eight years and four months, from April 2007 to July 2015, with an option to extend the lease term for two years each time, up to an additional eight years.

4.9 Intangible assets

4.9.1 License to provide Bezeq International services

Bezeq International operates within the framework of a general license for the provision of international telecommunications services, under the Communication Law, which anchors the right of Bezeq International to provide internet services. The license constitutes the basis for Bezeq International's operations.

4.9.2 Acquisition of Actcom Active Communications Ltd.

On 13 December 2006, Bezeq International signed a transaction to acquire 100% of the shares of Actcom Active Communications Ltd., Israel's first internet access service provider, from its two founders. Actcom, whose offices are in Haifa, shall continue to run its business as an independent subsidiary of Bezeq International. On 9 July 2007, the Registrar of Companies approved the full merger of Actcom and Bezeq International Ltd., under the provisions of section 323 of the Companies Law, 5759-1999, such that Bezeq International received Actcom (all of its assets, rights and liabilities) and Actcom was removed from the register.

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

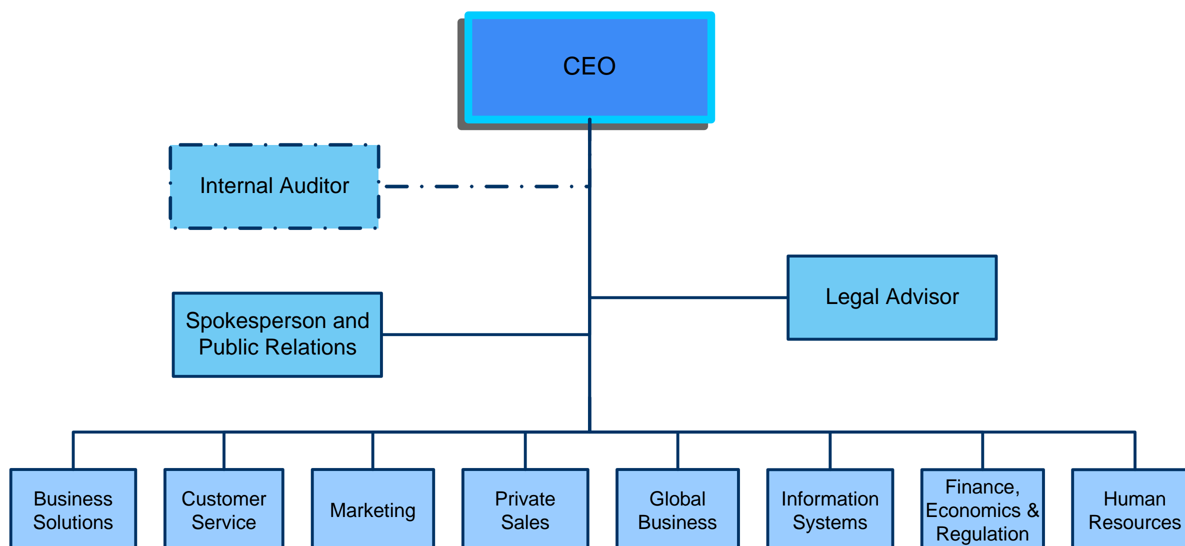
4.10 Human resources

4.10.1 On 18 June 2007, the appointment of the deputy CEO as acting CEO of Bezeq International was approved (in place of CEO of Bezeq International, who was appointed acting CEO of the Company). The position of deputy CEO of Bezeq International was cancelled. On 6 November 2007, the acting CEO's appointment as CEO was approved.

4.10.2 The number of persons employed by Bezeq International (employees of the Company, employees of human resource firms and outsourcing) is 2,621, of which 883 are headquarters staff.

4.10.3 <u>Organizational structure</u>

Below is the organizational structure of Bezeq International:



In 2007, Bezeq International's management resolved, with the consent of the board of directors, to alter the organizational structure of the Company, in the following way:

A. The organization and methods department will be transferred to the management of the finance department.

B. Human resources will be separated from the finance department into an independent department under the management of a manager reporting to the CEO of Bezeq International.

C. The operations division will be merged into the service division, under the management of VP Services.

4.10.4 Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives, such as sales employees, telephone sales representatives, and telephone service and support representatives.

4.10.5 Employees have a leasing arrangement enabling employees to receive vehicles at a cost determined in accordance with the terms of an agreement between Bezeq International and a leasing company. Employees also have an arrangement for pension and health insurance that is fully subsidized by the Company.

4.10.6 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.

4.10.7 All of Bezeq International's employees have standard personal contracts based on their professions and positions.

4.11 Suppliers

4.11.1 In February 2005, Bezeq International signed an agreement with SigValue to purchase an intelligent network system, the cost of which is not material. Bezeq International will be dependent on this provider.

4.11.2 Bezeq International has an agreement with Tadiran Information Systems Ltd. (which was acquired by IBM) which is implemented by IBM Global Services (Israel) Ltd. ("IBM") for the maintenance and development of service absorption and pricing and billing systems. Bezeq International is dependent on this service from IBM.

4.11.3 In 2004, Bezeq International set up a contact center (a system integrating switchboard, collaborative system comprising computer, switchboard and interactive voice response). This setup is used by Bezeq International's service, support and sales centers, and is

based on Avaya technology. For this purpose, Bezeq International signed a three-year agreement with IBM to provide ongoing support and maintenance.

4.11.4 Bezeq International has financial relations with some 100 foreign operators, in approximately 240 destinations worldwide. The substantial foreign operators in terms of size and cost of traffic passing through them include British Telecom, Rostelecom, Paltel, and AT&T.

4.11.5 Bezeq International is dependent upon international communications infrastructure provider Mediterranean Nautilus Limited, which supplies it with most of the international communications infrastructure that it requires through an underwater cable running from Israel to Europe. From there onwards, Bezeq International uses other infrastructure for connecting to the rest of the world.

As of the date of full merger, all of the rights and obligations of BezeqCall under joint venture, marketing and sale agreements to which BezeqCall has been a party, were transferred to Bezeq International, giving it the right to market and supply installation, support and maintenance for equipment sold as part of NEP services. The most significant agreements are with LG, Nortel, Cisco, and Tadiran.

4.12 Working capital

Bezeq International's cash item includes bank deposits for immediate withdrawal as well as fixed-term deposits on which there are no usage restrictions and whose repayment date, on their investment date, does not exceed three months.

4.13 Credit policies

4.13.1 <u>Credit to customers</u>

4.13.1.1 Most of Bezeq International's customers have credit terms of EOM + 45.

4.13.1.2 Equipment sold to internet customers is usually billed in 24 installments.

As part of NEP services, Bezeq International makes sales to its customers by payments in many instalments. In this way, Bezeq International gives its customers credit, which they repay in instalments. To reduce the exposure which might stem 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.

4.13.2 <u>Credit from suppliers</u>

Bezeq International receives credit from its suppliers for 30 to 120 days (usually 90 days).

4.14 Investments

4.14.1 At 31 December 2007, Bezeq International held 34.41% of the share capital of Walla! Communications Ltd. ("Walla") (33.66% at full dilution). Walla is an Israeli company whose shares are listed on the Tel Aviv Stock Exchange. Walla provides internet services and is an internet portal provider. In 2007, Bezeq International and others exercised option warrants of Walla (series 3). In all, Bezeq International exercised 508,979 option warrants (series 3) in 2007, for NIS 916,000, which was set off against the balance of the shareholders' loans provided by Bezeq International to Walla. Following exercise of the option warrants, the Company has a cost surplus of NIS 81,000.

Walla ended 2006 with a net profit of NIS 25.5 million and 2007 with a net profit of NIS 15.1 million.

For additional details regarding Bezeq International's investment in Walla, see Note 12 to the Company's financial statements for the year ended 31 December 2007, which are included in this periodic report.

4.14.2 <u>B-Zone partnership</u> – on 23 October 2006, Bezeq International signed an agreement with 2+ (Two Plus) Wireless Solutions Ltd. ("2+") for the establishment of a general partnership called B-Zone ("the Partnership"). Each party holds 50% in the partnership. The purpose of the partnership is to set up, support and manage wireless browsing networks in public areas, enabling connection to high-speed internet browsing and collecting payment from the end user for permission to

browse the internet ("the Area of Operations"). Under the agreement, each of the partners transferred its operations in the partners' area of operations to the partnership, effective from the date of commencement of the partnership. After the establishment of the partnership, the Company signed an agreement with 2+ to provide outsourcing services for the partnership by 2+, whereby 2+ attends to the day-to-day operation and management of the Partnership.

4.14.3 On 21 December 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. (Bezecom). Bezecom was set up as part of the expansion of Bezeq International's global operations, together with the DSNR Group, which specializes in online marketing. The purpose of Bezecom is to provide communication services to end customers around the world, inter alia through a unique communications solution to provide telephony services. Bezecom commenced development operations in March 2007, and in August 2007 commenced its commercial launch.

4.15 Financing

4.15.1 As of the date of the periodic report, the Company has no liabilities to banks and is not using its approved credit line.

4.15.2 The source of Bezeq International's finance in the past two years has been a positive cash flow from current operations.

4.15.3 Bank guarantees – In accordance with the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee of NIS 9.4 million and NIS 1.4 million to fulfill all of the conditions of the license to provide international telecommunications services. As at the balance sheet date, Bezeq International has provided additional bank guarantees of NIS 10.7 million.

In January 2007, Bezeq International repaid on-call loans provided to BezeqCall by a number of banks, in the amount of NIS 20.3 million.

In 2007, Bezeq International repaid all of BezeqCall's long-term bank loans, in the amount of NIS 47.6 million.

4.16 Taxation

See Note 8 to the Company's financial statements for the year ended 31 December 2007, which are included in this periodic report.

In February 2007, Bezeq International paid income tax down payments for the 2006 tax year, in the amount of NIS 36.3 million.

4.17 Bezeq International's operations: restrictions and supervision

4.17.1 <u>Legislative restrictions</u>

4.17.1.1 The Communications (Telecommunications and Broadcasts) Law, 5742-1982 and the general license to provide of international telecommunications services:

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, compliance of the licensee to 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. Pursuant to his declarations, the Ministry of Communications intends to exempt the supply of internet access services.

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 4.1.2 above.

4.17.1.2 Interconnectivity payments

The Telecommunications (Interconnect Fees) Regulations, 5760-2000 (the Regulations) regulate the payments made to the domestic operator or the cellular operator.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for completion of a call will be reduced from 1 March 2008 to a maximum tariff of NIS 0.22.

The above-mentioned tariffs, rounded to 12 seconds, will be updated once a year, starting from 1 March 2006, in accordance with the percentage of the change in the CPI.

4.17.1.3 Royalties

For payment of royalties, see sections 4.1.2.4 and 2.16.3 above.

4.17.1.4 Standards

Bezeq International holds ISO 9001:2000 certification for quality management systems and ISO 7799 certification for information security management systems issued by the Israel Standards Institute.

4.18 Joint venture agreements

In June 2003, Bezeq International signed an agreement with Infonet Corporation (Infonet) for the distribution of Infonet's data communications services. Infonet is a network connecting many sites worldwide and provides for the efficient transfer of data between these sites. In December 2003, an agreement was signed by Bezeq International and Kardan Communications Ltd. for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International, which received the equipment and rights to provide Infonet services in Israel, and it will provide technical support to all Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services.

In the first quarter of 2005, Infonet was acquired by BT, resulting in restructuring under which the infrastructure used by the companies to provide their services to Israel was unified. At this stage, neither the acquisition nor the restructuring have had any affect on the running of Bezeq International's business, nor on its sale of Infonet products.

4.19 Legal proceedings

4.19.1 In April 2004, a competing international communications operator filed a claim in the Jerusalem District Court against the State of Israel in the amount of NIS 11.2 million, for damages allegedly caused to it by a violation by the State of Israel of an obligation to place at its disposal part of the total capacity of an underwater cable (which was granted as part of the tender which opened the international communications market to competition in 1995).

In September 2004, the State of Israel filed a statement of defense and third-party notice against Bezeq.

Following negotiations between the parties out of court, they reached a settlement to cancel the claim against payment of sums that are not substantial to Bezeq International.

4.19.2 In January 2005, a claim for NIS 10 million was filed in the District Court in Tel Aviv against Bezeq International, two other international operators, and another company, alleging that a patent for a prepaid telephone system had been infringed by persons alleging that they are the inventors and owners of this patent. According to the plaintiffs, each of the

defendants is infringing the patent which they own and unlawfully enriching themselves at their expense. In the statement of claim, the plaintiffs demand that detailed reports of these revenues stemming from the infringement of the patent be submitted to them and that the full revenues, plus reasonable royalties and punitive compensation, be paid to them under the provisions of the Patents Law.

In April 2005, Alcatel took over management of the defense in this case, on behalf of Bezeq International, for one of the systems which are the subject of the claim (which it supplied), under the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated 13 December 1998 (Alcatel is replacing Tadiran for the purpose of this agreement).

In January 2008, the District Court accepted the joint petition of Bezeq International and the plaintiffs to postpone the determination of the pre-trial date by another two months and to allow the parties to inform the court whether they have reached a compromise or whether a new date for a hearing should be set, and determined that the update notice will be submitted before 20 March 2008.

4.19.3 In May 2006, Bezeq International filed an appeal with the Magistrate's Court at Tel Aviv against the Ministry of Communications' decision to impose financial sanctions on the Company in the amount of NIS 1 million for prima facie breach of the provisions of its license regarding erotic services

In January 2007, the court upheld the appeal in part, and the Ministry of Communications was required to refund Bezeq International the amount of NIS 387,000. Bezeq International filed an application for leave to appeal to the Tel Aviv District Court where it petitioned for refund of the rest of the sanction paid by it. On October 15, 2007, the District Court handed down a ruling setting aside the appeal and affirming the ruling of the Local Court.

4.19.4 In February 2007, Bezeq International filed a petition with the Supreme Court sitting as the High Court of Justice, to cancel a decision of the Minister of Communications made on 31 January 2007 to amend the policy of the Ministry of Communications regarding licensing of VOB services – under which decision Bezeq International would only be given a license to operate domestic land line telephony services using VOB technology after the Company's market share in domestic land-line telephony falls below 85%. The Supreme Court accepted Bezeq International's application and on 8 July 2007, awarded an interim injunction instructing 012 Telecom to focus its offers of domestic fixed line telephony engagements on their own customers only, by direct mailing and without addressing the public. On 5 September 2007, the Supreme Court ruled to dismiss the petition and allow the decision of the Minister of Communications to stand.

4.19.5 On 6 June 2007, HOT Telecom Limited Partnership ("HOT") filed a claim against Bezeq International in the Tel Aviv District Court, under which it sought declaratory relief and an interim injunction under which Bezeq International would not take any steps, directly or indirectly, to obtain confidential information belonging to it, and would not use such information should it be obtained. This was following HOT's investigation that indicated that Bezeq International was allegedly operating unlawfully to obtain the details of customers who had joined as subscribers to its internet access infrastructure services.

Bezeq International filed its response to the application for temporary injunction to the court, in which it alleged that HOT's claims against Bezeq International and its managers regarding the existence of methodical and systematic operations at Bezeq International aimed at unlawfully obtaining information about HOT's customers are insubstantial and that in any event, there is no evidentiary infrastructure for such, and that if any of Bezeq's representatives indeed acted as alleged by HOT, such person acted of their own accord, in absolute contravention of the instructions of Bezeq International.

On 23 July 2007, the Court acceded to HOT's application and awarded an injunction prohibiting Bezeq International and/or any of its employees and/or persons acting on its behalf and/or any of its representatives from contacting the employees of HOT and/or its representatives directly or indirectly to obtain confidential information regarding the identity of its customers, by way of grant of benefits and/or making use of such information that may have reached it. In view of Bezeq International's clear policy, which also existed prior to the filing of this claim, and which prohibits unauthorized receipt and use of such information, it would appear that the injunction granted by the court will not have any implications on Bezeq International's operations or its financial results. As of the date of this report, Bezeq International's response to the principal claim (regarding the declaratory relief) has not yet been submitted; however, at this stage,

given the causes of action and Bezeq International's clear policy regarding the receipt of information relating to customers of infrastructure suppliers, it would appear that the claim will not substantially affect the conduct of Bezeq International's business, or require it to use substantial resources to remove it.

4.19.6 On 29 July 2007, Bezeq International filed a claim against HOT in the Tel Aviv District Court in the amount of NIS 23.2 million for damages caused to it by HOT since the latter decided, in contravention of the provisions of its license, not to allow Bezeq International to participate in the joint parcels it offers (joint parcels for access services and infrastructure services at an attractive price). The lawsuit was filed following the Ministry of Communications' decision in October 2006 (following Bezeq International's complaints on this matter), according to which HOT is in violation of the terms of its license and therefore is obliged to include the Bezeq International in its combined packages, together with the other internet access service providers in competition with Bezeq International. In the statement of claim, Bezeq International claims loss of profits in the amount of NIS 23.2 million during the two years (2005-2007) in which HOT blatantly refused to cooperate with it. According to Bezeq International, during this period it lost many customers who wanted to benefit from its services but wanted HOT's infrastructure services. Due to HOT's conduct, Bezeq International was in fact obstructed from accessing a whole sector of customers which it could not bring into its services or retain. As of the date of this report, HOT has not yet filed a statement of defense.

4.19.7 Further to the provisions of the update to section 2.6.6A above, on 27 May 2007, Bezeq International received a letter from the Director General of the Ministry of Communications, in which he notified the Company that he intends to impose a financial sanction of NIS 2,031,750 on the Company for failure to apply and operate the number plan and number portability, from on 1 September 2006.

In response to the Ministry of Communications, Bezeq International contended that as holder of a general license for providing international telecommunications services, it does not allocate numbers to its customers and therefore, in any event, is not part of number portability, which is implemented by domestic and cellular operators. Bezeq International's part in this matter begins and ends with the building of the interfaces required for incoming calls to cellular and/or domestic operators, according to the characterization of the number portability configuration determined by the cellular and domestic operators, and the relevant tests. Bezeq International fulfilled its lawful duty by making appropriate preparation and it was ready, prior to the date set for implementation of the portability plan on 1 September 2006, to do everything necessary for implementation of the plan in the way that would be decided by the domestic operators, and nothing it did would prevent the realization of number portability from any customer whatsoever.

This being the case, the allegations made by Ministry of Communications are groundless, and not only do they contradict the facts of the matter, but also caused anguish to Bezeq International, which invested extensive resources and acted tirelessly to implement what was required of it, by the date and in the manner prescribed by the relevant persons. In view of the above, it is clear that Bezeq International implemented number portability faultlessly, and it should be seen as having been ready to apply number portability in accordance with the provisions of the law and by the date prescribed therein.

4.19.8 For further legal proceedings, see Note 17 to the Company's financial statements for the year ended 31 December 2007, which are included in this periodic report.

4.20 Goals, business strategy and expected development

4.20.1 As part of the preparations for 2007, Bezeq International set itself a number of key goals outlining the nature of its operations and reflecting the strategy which it adopted during the year.

4.20.1.1 To retain global leadership in ISP

4.20.1.2 To implement a quality merger process with BezeqCall at the employee, processes and customer levels, effecting merger synergy

4.20.1.3 To create loyalty by improving customer satisfaction and experience for Bezeq International customers

4.20.1.4 To continue to attract excellent employees

4.20.1.5 To improve effectiveness and efficiency of cross-organizational work processes

4.20.1.6 To time investments as a tool for retaining the stability and growth of Bezeq International

4.20.2 Bezeq International's goals for 2008

4.20.2.1 To reinforce customer loyalty by improving customer satisfaction and experience

4.20.2.2 To establish leadership in the customer's perception and the market share in the internet sector

4.20.2.3 To maintain its status as an international call provider

4.20.2.4 To realize the potential in the business segment, while constructing an organizational infrastructure that supports solutions for business customers

4.20.2.5 To develop the Company's potential in international markets

4.20.2.6 To adapt the Company's budget structure to the new market

4.20.2.7 To realize synergies from the mergers

4.20.2.8 To empower and develop the Company's human capital

4.20.2.9 To establish and realize the potential of the technology system and adapt it to the Company's business requirements

4.20.3 2007 was characterized by continued growth and increases in Bezeq International's revenues and operating profits.

4.20.4 In 2007, Bezeq International increased the range of communications solutions that it provides to its commercial customers. During the year, Bezeq International completed all of the procedures for the merger with BezeqCall. Bezeq International views this field as having growth potential and plans to further establish its status in this area.

4.20.5 The year 2007 was characterized by a continued increase of Bezeq International's operations in supply of internet access services in general, and broadband internet in particular, including a range of added value services and Datacom operations to international customers. In this way, Bezeq International continued to reduce its reliance on revenues from international outgoing call services.

4.20.6 In 2007, Bezeq International improved its market position in all the areas of its operations.

4.20.7 In 2007, Bezeq International continued to invest in its customer service system, which provides service and technical support to its business and private customers.

4.20.8 The above information is forward-looking and as such is not certain and may not become reality, in full or in part. The forward-looking information is based on information that Bezeq International currently has as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report The actual results could be significantly different from the results that are estimated or implied from this information.

The forecast of Bezeq International's management is based on forecasts related to the continued recovery in the Israeli market, continued penetration of broadband technology and continued growth in the number of internet users. The above forecast may not become reality at all or may become reality in part only, owing to a slump in the Israeli economy which will reduce purchasing power in Israel, regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and all the other risk factors listed below.

4.21 Risk factors

A. Changes in exchange rates – The main currency used by Bezeq International is the shekel, which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from customers in Israel. In addition, Bezeq International provides services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. On the other hand, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. Changes in the exchange rates of the currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its

cash flow. To protect itself against currency exposure, Bezeq International enters into hedging transactions and purchases other financial instruments.

B. Competition – For the effect of the competition on Bezeq International's businesses, see section 4.6. above.

C. Investments in infrastructures, technological changes and dependence on suppliers – See Section 4.11 above.

D. Government supervision and regulation – For the application of the provisions of the law and licensing policy and their effect on Bezeq International, see sections 4.1.2 and 4.1.3.1 above.

E. Legal proceedings

Bezeq International is a party to legal proceedings, including class actions, which could result in its being required to pay substantial sums. A provision has been made in Bezeq International's financial statements for the 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 4.19 above.

Summary of risk factors

	Effect of risk factor on Bezeq International's operation		
	Major effect	**Moderate effect**	**Minor effect**
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

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

5.1 General Information on Area of Operations

DBS, known also by the trading name of "yes", provides multi-channel broadcast services to subscribers via satellite. DBS was founded on December 2, 1998, and has been providing this service since July 2000.

This service allows for the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via a small antenna dish from which broadcasts are transmitted to a domestic decoder in the subscriber's home and connected to the television set.

Most of DBS's income stems from subscription fees and additional payments made by viewers.

As at December 31, 2007, DBS had 549,252 subscribers.

DBS is the only company currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure and changes in area of operations

The area of broadcasts is regulated and operations in the area are effected via various broadcast licenses. The heavy regulation of the field of broadcasting includes the obligation to receive a license, the obligation to operate in accordance with the relevant provisions of the Communications Law, the provisions of the various licenses and the conditions thereof, and constant supervision of the Ministry of Communications and the Cable and Satellite Broadcast Council (hereinafter: the "Council").

Multi-channel television broadcasts have been offered in Israel since the mid-1990s, via companies which supplied cable television broadcasts. Those companies operated first under regional franchises on conditions of exclusivity, which were granted to them, and since 2002 they operated by virtue of long-term broadcast licenses which replaced the franchises. In November 1999, these companies were declared to have a monopoly in the field of multi-channel television broadcasts in the areas of the franchises in which they operated at the time, by virtue of the Antitrust Law, 5748-1988. As of the end of 2003, the cable corporations worked jointly in a number of areas of operations, under the brand name HOT. In December 2006, the cable corporations merged into a single merged cable company, HOT Cable Communications Systems Ltd., which supplies television services by cable to all of the subscribers of the cable corporations that were merged into it (the "**cable company**"). The cable company holds all of the rights in a limited partnership which owns the cable network infrastructure, including the terminal equipment and broadcast centers, and which, to the best of DBS's knowledge, provides communications services, internet access and telephony services.

For the free distribution of certain television channels via a digital terrestrial broadcast system, see section 5.1.3.3.

To the best of DBS's knowledge, the Ministry of Finance is working on publication of a tender for the set-up and operation of a system for terrestrial distribution of digital radio broadcasts. This distribution system might also constitute infrastructure for providing television services to mobile terminal handsets, which will constitute a rival service to the services provided by DBS. As at the date of publication of this periodic report, the tender has not yet been published.

5.1.2 Statutory restrictions and special constraints

The Communications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license by virtue of the provisions of the law and pursuant to the Telecommunications (Proceedings and Conditions for the Grant of a Satellite Broadcasting License) Regulations 5758-1998 (hereinafter: the "Broadcast License").

The broadcast license granted to DBS is in force until 2014. At the end of that period, the broadcast license shall be renewable for additional periods of six years each, subject to the conditions of the license.

For additional licenses granted to DBS, see Section 5.8.1 below.

Operations in the field of broadcasting and other fields of communications are subject to licensing, supervision and the policy decisions of the Ministry of Communications, in aspects defined in the Law and the communications licenses (which relate, mainly, to matters relating to competition, consumers, and technical and engineering aspects). In recent years, due to the process of closer connections between the field of broadcasting and other fields of communications, and particularly due to the operations of cable companies and entities related to it in the field of telephony and internet, the field of broadcasts is substantially influenced by the policy and supervision of the Ministry of Communications in various areas that relate to or touch the field of broadcasting.

DBS' and the cable company's broadcasting operations are also under the constant supervision of the Council. The Council sets policy and makes rules regarding the content of broadcasts, the duty regarding original Israeli productions, the division of content into genres, broadcasting ethics, consumer protection and other matters in the area of broadcasting policy. The Council is also responsible for enforcing the various statutes relating to the field of broadcasting, for approving the channels that DBS wishes to broadcast, or to cease broadcasting, and is also authorized to amend the broadcast licenses of DBS and the cable company under the conditions set out therein.

The Council has authority in the field of consumer protection, so that the setting of price lists, updating of price lists and offers to customers require its consent or the giving of prior notice (on the issue of DBS's activities being subject to legislation and to the supervision of the Ministry of Communications and the Council, see also section 5.15 below).

Changes may be made to the identity and nature of the persons supervising the operations of the players in the field of licensing and supervision of the field of broadcasting (including DBS's operations), at the initiative of the government.

In 2005, the government resolved to consolidate the Council's activities with those of the Second Television and Radio Authority and the Public Broadcast Regulation Administration into a unified commercial broadcasting authority. This decision was anchored in a government bill, but to the best of DBS's knowledge, the bill has not been discussed. In addition, to the best of DBS's knowledge, in the past, the government examined setting up a communications authority which would replace the Ministry of Communications and the authorities described in section 5.1.1 above, and which would have all of the powers of such authorities, despite the abovementioned delay.

5.1.3 <u>Developments in markets in the area of operations</u>

In recent years, a number of trends have arisen in the broadcasting industry which have affected competition in it:

5.1.3.1 The offering to consumers of a "total bundle of services" which includes, in addition to multi-channel television services, internet connection infrastructure (at high speeds) as well as fixed-line telephony services (a bundle which contains these three services is also called "triple play"), and there is increasing demand for purchase of such communications service bundles. This trend follows the combined offer of television services with internet connection services that had been employed previously.

5.1.3.2 The offer of advanced television services with added content, including VOD, PVR and HD (see section 5.1.4 above).

5.1.3.3 Pursuant to an amendment to the Second Television and Radio Authority Law, 5750-1990 of February 2008, the Second Television and Radio Authority is required to set up a system whereby the television channels of the Israel Broadcasting Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) would be distributed to the public freely, nationwide, via a terrestrial transmission service using digital technology, backed-up by a digital satellite system (known as DTT). This distribution system will be a partial substitute for DBS's transmissions which, in DBS's assessment, is likely to cause substantial harm to its revenues. In January 2008, a private member's bill was submitted to the effect that the DTT system will also include the transmission of two special channels broadcast as at the date of this report (a Russian language channel – Channel 9 – and the Music 24 Channel), and the Educational Television channel. Increasing or varying the number of channels distributed via the distribution system is expected, in DBS's assessment, to increase

the extent to which the system will substitute for DBS's services, and therefore, might bring about an increase in the harm caused to DBS's revenues.

5.1.3.4 In addition, in August 2005, the government resolved to require the Minister of Communications and the Minister of Finance to do all of the acts required in order to enable the public, no later than January 1, 2007, to purchase a basic television services package from the multi-channel television companies (the cable and satellite companies) including connection to the distribution infrastructure of DBS's broadcasts, and reception of the television channels of the Broadcast Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10), the Knesset Channel (Channel 99), the Educational Channel (Channel 23) and the designated channels, without the consumer being required to purchase any other services from the multi-channel television companies. To the best of DBS's knowledge, as at the date of this report, the government is not promoting legislation to implement this decision. In addition, a number of private member's bills have been submitted to require the broadcast companies to offer a basic television service package. Likewise, this issue is one of the matters being discussed by the Grunau Commission (see section 5.1.3 below), although it is not certain whether the Commission will submit recommendations on this matter. In DBS's estimation, requiring it to offer a basic services package might harm its revenues.

5.1.3.5 In February 2007, the Minister of Communications appointed a Commission to formulate detailed recommendations regarding policy and rules of competition in the field of communications in Israel, headed by Prof. Reuven Grunau, with the aim of advising the Minister of Communications as to how to adapt the policy derived from the regulation targets to the new circumstances of the market. Among the matters on the agenda of the Commission was a series of issues that have direct relevance to DBS's operations, including questions regarding structural separation and the rules of structural separation that apply to the Company, the marketing of service bundles, formats for regulating the transition of content players on other platforms, including platforms with the potential to compete with DBS, such as unbundling issues, IPTV (see section 5.1.4 below) and others. The Commission has stated that it reserves the right to deal with such other issues as it may see fit, and therefore, it may deal with other matters affecting DBS's operations. In March 2007, DBS submitted its position to the Commission. In January 2008, the Commission informed DBS that it was considering recommending that the Minister of Communications require DBS and the cable companies to transmit a reduced basic broadcast package to their subscribers at a significantly cheaper price than the basic package price. DBS expressed its objection to this recommendation and to the fact that the Commission is discussing the issue. In the opinion of management of DBS, in light of the issues that the Commission is due to discuss, its decisions, if passed and adopted by regulators or in legislation, might have a significant effect on DBS's revenues.

5.1.4 <u>Technological changes that significantly impact on the area of operations</u>

5.1.4.1 Technological developments and changes which have taken place in the field of digital broadcasting enable the provision of "personal television" services, which include bi-directional services that enable reciprocal communications between the individual subscriber and the service provider, and immediate provision of the service individually selected by the subscriber. The principal service in this field at present (even in Israel) is the provision of television services upon the immediate demand of subscribers, also known as Video on Demand (hereinafter: "VOD services"). As at the date of this report, VOD services are only provided by the cable company and this has a substantial effect on competition in the field of broadcasting (in this regard, see section 5.6.5F below).

5.1.4.2 Around the world, video over broadband content transfer services have developed, whether in closed / managed systems or over the public internet, and these are known as IPTV (Internet Protocol Television). These services and abilities enable the consumer to watch video content (either by transferring content to all users or by transferring individually upon demand), the content sometimes being viewed via a personal computer and at other times via the

television. In Israel, this service has not yet been developed in a closed network, and broadband infrastructure owners might act to launch such services in the future, and entry of another service provider into this field might adversely affect the players in the field of broadcasts. However, as at the date of this report, video content is being transferred over the internet (in both local sites designed for Israeli audiences and foreign sites, and via file sharing software), and the development of this trend might substantially affect the field of broadcasts, which is currently based on special infrastructure, and might enable the supply of varied video content without needing a special infrastructure system.

5.1.4.3 Use of decoders which are able to record content broadcast on various channels onto a hard disk, known as personal video records (hereinafter: "**PVRs**"). The PVRs sold by DBS interface with DBS's electronic broadcasting timetable and enable the receipt of special services regarding the content that is broadcast, including ordering recordings in advance, recording series and suspending live broadcasts. DBS provides its subscribers with PVR decoders known by the brand name of "yesMax". Launch of PVRs to DBS subscribers is, in DBS's assessment, a partial response to the lack of VOD services to its subscribers.

5.1.4.4 At the end of 2007, high resolution television broadcasts were launched in Israel, known as High Definition TV (HDTV). These broadcasts, which are supplied as at the date of this report in a small number of channels, enable higher quality viewing. In DBS's opinion, even though at the date of this report this is a relatively limited service, the development of this service might substantially affect the field of broadcasting.

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

DBS regards the following factors as critical to the success of its operations:

5.1.5.1 Differentiation, innovation and originality in the content, branding and packaging of its broadcasts compared with the broadcasting content of its competitor, the cable company. These factors are reflected in the purchase and production of content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the production and purchase of original Israeli programming. For such purpose, ongoing investment is required in the area of production and purchase of the content of broadcasts supplied to DBS customers.

5.1.5.2 The ability to offer subscribers "personal" television services, and in particular, VOD services and PVR machines. (See section 5.6.5F below).

5.1.5.3 The ability to offer a bundle of communications services including television services and other services such as telephone services and internet services (see section 5.6.5F below).

5.1.5.4 Differentiation at the customer service level provided to DBS subscribers, which constitutes a material success factor in DBS' ability to retain customers in a competitive market.

5.1.6 Principal entry and exit barriers

5.1.6.1 The main entry barriers into the area of operations are: (a) the need for appropriate licenses under the Communications Law; (b) the immense investments required to be made by carriers in the area of operations, including for the purpose of setting up appropriate infrastructure and purchasing and producing content; (c) the limited size of the broadcast market which reduces the size advantage characteristic of the broadcast field around the world; (d) saturation of the broadcast market.

5.1.6.2 Recently, some of these entry barriers started to wear away as a result of regulatory changes (such as DTT – see section 5.1.3.3 above) and as a result of technological developments enabling the transfer of content over alternative infrastructure (such as IPTV – see section 5.1.4.2 above).

5.1.6.3 The principal exit barriers are: (a) the regulatory barrier – termination of operations under the broadcast license depends on a decision of the Minister of Communications to cancel the license prior to the end of the license term, under the conditions set out in the license, including arrangements for ensuring the

continuation of broadcasts and services and reduction of harm to subscribers. The licensee is required to continue providing the services under the broadcast license until the date prescribed by the Minister or until completion of such arrangements as the Minister may instruct, whichever is the later; (b) long-term contracts with important suppliers.

5.1.7 Alternatives to and changes in products of area of operations

With respect to multi-channel television broadcasts, the following principal services can be classified as alternative products:

5.1.7.1 The variety of territorial channels and other channels broadcast for free to the Israeli public. These channels include Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the commercial Channel 3 ("Channel 10 Israel"), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel ("Music 24"), the Russian-language channel ("Israel Plus"), and the Shopping Channel. In addition, many foreign channels that can be received in Israel via relatively cheap terminal equipment are another alternative product to DBS's services.

For the set-up of a digital terrestrial transmission system for distribution of various channels and bills to expand the channels broadcast over such system, see section 5.1.3 above.

5.1.7.2 Access to video content over broadband, including internet (see section 5.1.4.2 above).

5.1.7.3 DVD libraries.

5.1.8 **Structure of competition in the areas of operation and changes therein**

The concentrated and complex ownership structure in the areas of content, communications and infrastructure in Israel is likely to cause groups throughout the chain of production, packaging and supply of content to move into positions of control. The cable company which, together with the corporations related to it, has a broad deployment of advanced broadband infrastructure, markets and sells a package of services including multi-channel television services, high-speed internet infrastructure, and fixed-line telephony. Sale of a service package containing the above three kinds of communications services (known as triple play) whilst DBS, which does not have the infrastructure for providing telephony and high-speed internet access services, and is prevented from offering such a package together with the Company (see section 5.6.4.1 below) does not offer a similar package, is a principal component differentiating the offer to potential subscribers.

DBS, by cooperating with the Company, sells a service package that includes the multi-channel television services provided by it, and the Company's high-speed internet infrastructure, thereby providing a partial response to the 'triple' service package sold by the cable company (for this cooperation, see section 5.6.5G below).

5.2 Products and Services

DBS's broadcasts provide its subscribers with a wide variety of channels: Around 160 different video channels (of which 30 are pay per view channels) and another 20 radio channels, 30 music channels and 20 information channels (including portals), and interactive services.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport package and the science and nature package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is looking into the possibility of obtaining approval to launch VOD services (see section 5.6.5F below).

DBS sells its subscribers decoders which are essential for receiving its broadcasts, some of which also act as PVRs (see section 5.1.4.3 above). In December 2007, DBS began also selling HD broadcasts, and decoders intended to receive such broadcasts (see section 5.16 below).

5.3 Revenues and Profitability of Products and Services

Following is a table containing a breakdown of DBS' revenues (in NIS millions):

	2007	2006
Revenues	1,415	1,356
Gross profit	298	216

5.4 New Products

5.4.1 DBS is working on launching **VOD services** for its subscribers. Following a legislative amendment in 2007, DBS is permitted to launch these services via DSL infrastructure, however, the launch is subject to obtaining a suitable license and to arriving at a commercial and technological agreement with the owner of the infrastructure (the Company). To the best of DBS's knowledge, launching this to all of its subscribers will also involve an upgrade of the Company's infrastructure. At the same time, DBS is looking into other alternatives to launching VOD services in other formats – see section 5.6.5F below.

5.4.2 **High Definition TV (HDTV)** – at the end of 2007, DBD launched high definition broadcasts and began selling a decoder that enables reception of broadcasts in this format.

5.4.3 **Content viewing on a website** – in August 2007, DBS launched a content site on the internet in cooperation with Walla! Communications Ltd., which permits the viewing of various forms of content.

5.5 Marketing and Distribution

The marketing of DBS's services is by way of publication in the various media. DBS's sales operations are effected over three main distribution channels:

5.5.1 Sales people in the field working to recruit subscribers.

5.5.2 Telephone service center receiving telephone enquiries from customers wishing to receive DBS services.

5.5.3 External resellers of telecommunications services under contracts with DBS. DBS has some dependence on an external reseller who works to recruit subscribers among one of DBS's target groups.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 Competitors in the broadcasting market

DBS is in principal direct competition, as set out in section 5.1.1 above, with the cable company.

DBS estimates its share of the multi-channel television market as at December 31, 2007, to the best of its knowledge, at around 37% of total subscribers.

5.6.2 Broadcasting characteristics of the competitors

DBS's competitor is the cable company. For the operations of the cable company see section 5.1.1 above.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the cable company transmits its broadcasts to most of its subscribers using a digital broadcasting method and the above-mentioned tiering, while for the

remainder they use an analog broadcasting method, which allows for lower-quality viewing, does not enable display of an electronic broadcast timetable and requires purchase of a uniform channel package without the option of choosing broadcast segments (for further implications of this difference, see section 5.6.4 below).

5.6.3 Characteristics of the current competition

After DBS achieved high rates of growth in subscribers during the first years of its operations, inter alia due to temporary regulatory concessions given to it and a considerable technological gap, together with high churn rates amongst subscribers of the cable company, in 2006 and 2007 there was a relatively slow increment in the number of DBS subscribers, as set out below.

	2006	2007
Increase in number of subscribers	18,887	9,694
Rate of growth	3.6%	1.8%

At present, competition in the field of broadcasts is focused on broadcast content, on the proposed channel packages, on the price of channels and packages, on the field of service, and on the offer of additional services, including VOD services that are provided by the cable company, PVR decoders and HD broadcasts. Competition is also characterized by offers of other communications services as part of the service package (see section 5.6.5G below).

5.6.4 Positive and negative factors regarding the competition

5.6.4.1 In the estimation of DBS management, DBS has competitive edges, the principal ones being:

A. DBS makes use of advanced digital technology, which contributes to picture and sound quality; enables a fast and convenient user interface for subscribers when watching broadcasts; enables translation of the broadcast content into foreign languages and the additional of dubbing into other languages (such as into Russian), at the subscriber's election (in most of the Company's "home channels"); and enables the user to choose a language interface from four options (Hebrew, English, Arabic and Russian). In addition, DBS transmits wide screen broadcasts in a variety of channels which allows subscribers to watch broadcasts in wide screen format (which is similar to the format used in cinemas) on television sets. DBS broadcasts a number of channels using sound technology known as Dolby Digital (which is only supported by some of the decoders). DBS has also recently begun marketing HD services (see section 5.4.2 above).

B. DBS's broadcasts are transmitted via satellite, and therefore the broadcasts can also be received in remote or isolated areas in which there is no access to cable infrastructure.

C. The quality and variety of content broadcast by DBS to its subscribers.

D. The level, quality and availability of DBS's customer service system, both telephone service and technical service.

E. Accessibility and fast installation of equipment for receiving DBS broadcasts for customers living in buildings that are not connected to multi-channel television infrastructure in remote or isolated areas.

5.6.4.2 However, DBS' competitive operations suffer from inferiority or from factors that adversely affect it, in a number of areas, the main ones being:

A. Inferiority of infrastructure with respect to the option of offering 'personal television' services such as VOD (see section 5.6.5F below).

B. Some of the cable company's customers are customers of analog cable systems (see section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the cable company has much greater access to them since the analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.

C. The directives issued by the administration of the Ministry of Communications, relating to the bi-directional transfer of subscribers between DBS and the cable company and use of the infrastructure installed in the homes of subscribers, require 36 hours' notice before disconnection of an existing subscriber of the cable company (and vice versa in the case of disconnection of an existing DBS subscriber). The cable company can exploit this time frame to make special offers to existing subscribers about to leave it for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the cable company, the administrative orders stipulate that payment must be made thereof (and vice versa). However, as at the date of this report, neither the cable company nor DBS is in full compliance with the administrative order. For this and the hearing being conducted by the Ministry of Communications with respect to internal wiring, see section 5.15.3 below.

D. DBS has infrastructure inferiority which does not permit it to transmit telephone and internet services over its infrastructure, as opposed to the cable company whose infrastructure enables the provision of such services. This inferiority is even greater given the regulatory restrictions imposed on DBS and on the Company, which restrict DBS's ability to offer telephony services using the Company's infrastructure, and the lack of any realistic ability to market the telephony services of the cable companies.

E. Regulatory restrictions of structural separation, including restrictions in the field of joint marketing of products and services, between the Company and its subsidiaries and certain affiliates, including DBS, restrict DBS's operations. So long as these restrictions remain in force, and at the same time, there are no other similar restrictions on the cable company (and corporations related to it in the field of telephony and internet) harm DBS's ability to offer a bundle of services at a competitive price. In addition, there are regulatory restrictions imposed upon the Company with respect to the injection of funds into DBS. Since the Company is a shareholder of DBS, DBS is subject to the restriction on obtaining a license to supply telephony services itself over broadband internet (VOB), whilst telephony services are offered to subscribers of the cable company.

F. DBS has significant expenses involved in leasing space segments, which are necessary for the purpose of providing DBS's broadcasts.

G. DBS views the development of IPTV services in Israel as being a factor that might adversely affect its competitive standing in the broadcast field, including entry of additional competitors into the field of multi-channel broadcasts.

5.6.5 <u>Principal methods for coping with competition</u>

The following are the main methods used by DBS to deal with competition in the field of broadcasts:

A. 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 emphasized its customer service and technical service systems;

D. Technology – continuing investments in technological capabilities and quality of DBS's broadcasts; emphasizing technological innovation;

E. PVRs – since DBS views the supply of "personal" television broadcasts as an integral part of the services provided by those operating in the broadcasting market in this modern era, and a significant component of the total bundle of services offered to subscribers, At the beginning of 2005, DBS launched PVR decoders under the brand name yesMax. In 2007, DBS significantly increased the rate of penetration of PVR decoders among its subscribers. To the best of DBS's knowledge, the cable company also sells PVR decoders to its subscribers.

F. VOD – whilst the cable company commenced providing VOD services to its subscribers at the beginning of 2005, as at the date of this report, DBS has not yet launched such services.

In light of the abovementioned infrastructure inferiority, DBS applied to make use of the high-speed bi-directional infrastructure (digital subscriber line – DSL) owned by the Company and to provide its subscribers with VOD services over such infrastructure.

In July 2007, the Communications (Telecommunications and Broadcasts) (Amendment No. 37) Law, 5767-2007 was enacted. Inter alia, this law authorizes the Minister of Communications to grant a satellite broadcast licensee permission to supply broadcasts on demand (VOD) to all or any of its subscribers, after consulting with the Council and taking into account the considerations set out in the Communications Law, if he finds that there is difficulty transmitting VOD broadcasts via satellite in a scope and format similar to those broadcast by the general cable broadcast licensee. However, commercial launch of VOD services by DBS requires the receipt of a license from the Ministry of Communications, that the subscriber be connected to the DSL network and receipt of the consent of the Company to provision of the service under conditions that will make it possible for DBS to supply the service to its subscribers, conditions which, at present, have not yet been fulfilled. DBS is also looking into other alternatives to providing VOD services.

G. "Bundle of services" – as set out in section 5.1.3.1 above, a trend has developed in the field of broadcasts of offering a bundle of communications services as a marketing measure to recruit customers and to retain them, and there is an increasing demand on the part of consumers and potential consumers to receive a total bundle of services enabling them to receive multi-channel television services, high-speed internet connection infrastructure services and fixed line telephony services from one source at lower prices than the prices paid for purchase of each of these services separately.

As a result, DBS currently sells a service package, together with the Company, which includes broadcasts and infrastructure to connect to high-speed internet services. However, due to regulatory restrictions imposed upon the Company with respect to structural separation between it and its subsidiaries and certain related companies, including DBS, contrary to the cable company, which sells its subscribers a triple bundle of services, under which it can also reduce the prices for the bundle of services, DBS is unable to offer a similar bundle at a competitive price.

Letters from the Ministry of Communications to DBS show that the Ministry of Communications is of the opinion that DBS is not permitted to market the Company's telephony services, and this is contrary to DBS's view.

H. As part of DBS's efforts to provide a response to the bundle of services marketed by the cable company, DBS has worked to obtain a license to provide telephony services via broadband access – Voice over Broadband (hereinafter: "**VOB**"). In January 2007, the Minister of Communications published the Ministry of Communications policy regarding the grant of licenses for the supply of VOB services, in which it was prescribed, *inter alia*, that DBS is not entitled, at this stage, to receive a license to supply VOB services until the Company's market share in the field of domestic fixed-line telephony fell below 85% (subject to a check point at the end of one year). DBS is looking into the possibility of selling VOB services provided by a third party.

5.7 Property Plant & Equipment

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re'em Junction, leased space segments on the Amos 1 and Amos 2 satellites (for lease conditions see section 5.16.2 below) and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

5.7.1 <u>Rental of structures</u>

DBS's principal offices, including its management offices, the broadcast center and other operations departments, are in three buildings in the Eastern Industrial Zone at Kfar Saba, in an area covering approximately 9,701 sqm, alongside which there is a parking lot and adjacent facilities: An area of approximately 7,715 sqm (in which the broadcast center is situated) are leased by a third party, in accordance with a memorandum of understanding dated May 1999. This lease ends in November 2009, and DBS has an option to extend the

term of the lease by 10 more years under the same conditions. DBS has a right of first refusal to purchase the premises from the lessor, should such be put up for sale; an area of approximately 1,994 sqm in another adjacent building is leased by a third party, the term of which lease ends in July 2008.

In addition, DBS runs two operational centers, one being in the Nesher Industrial Zone (some 1,522 sqm in area, which is leased by a third party until May 2008) and the second in the Industrial Zone at Kanot (some 1,487 sqm in area, which is leased to a third party until July 2011), and thee are used as technical service and sale centers for subscribers in the north and south of the country; in addition, nation-wide telephone service centers operate from them. DBS also runs two employee recruitment centers.

5.7.2 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 infrastructure to the subscriber's television screen (including PVR decoders and HD decoders) as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see Section 5.16.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them.

5.7.3 Broadcast equipment

In addition, DBS's plant and equipment also includes the broadcast and reception equipment at the central broadcasting center at Kfar Saba, which includes the reception systems at the broadcast centers, the compression, encryption, playing and uplink systems, and the compression systems at the secondary broadcast center at Reem Junction.

5.8 Intangible assets

5.8.1 Licenses

DBS owns the following main licenses:

5.8.1.1 Broadcasting license valid until January 2014 – this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see section 5.15.2 below).

5.8.1.2 License for satellite television broadcasts in the Judea and Samaria region valid until January 2009, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judea and Samaria region.

5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until January 2014 or until the end of DBS's broadcast license, whichever is the earlier. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

5.8.1.4 License for the provision of uplink/downlink services to other communication licensees which is valid until July 2008. As at the date of publication of this report, DBS does not use this license.

5.8.2 Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered on the Register of Trademarks. The main registered trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

5.8.3 <u>Costs of acquisition of subscribers.</u>

See Note 3 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

5.8.4 <u>Software</u>

See Note 3 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

5.9 Broadcasting rights

5.9.1 DBS holds the broadcast rights of television content purchased from the owners of intellectual property rights in such content. Sometimes, DBS purchases the right to sell these content broadcast rights to third parties together with the rights themselves, for the purpose of broadcasting the content again. As at the date of this report, revenues from these sales do not amount to a significant percentage of DBS's revenues.

5.9.2 The broadcast of content in which DBS owns broadcast rights involves the payment of royalties to the owners of intellectual property – i.e., copyright and performers rights in sound recordings for actual broadcasting, including under the Copyright Law, 5768-2007 and the Performers and Broadcasters Rights Law, 5744-1984. Payment of royalties as aforesaid is done via a number of organizations that operate in Israel, which collect the royalties owing to the owners of the intellectual property rights and in return provide the broadcasting entities with blanket licenses. For some of these licenses which represent principal royalty payments, the final sum owing from DBS for uses under the license is prescribed in accordance with the final sum paid by the cable company to the licensee for every subscriber, either in the case of an agreement between them and the licensee or in the event of a judicial ruling on a dispute between the parties, the consideration owing from DBS being no less, in any event, than that paid currently under the license. Payments by DBS under these licenses are based mainly on a fixed payment and sometimes on various pricing methods, including those that depend on the number of subscribers as aforesaid.

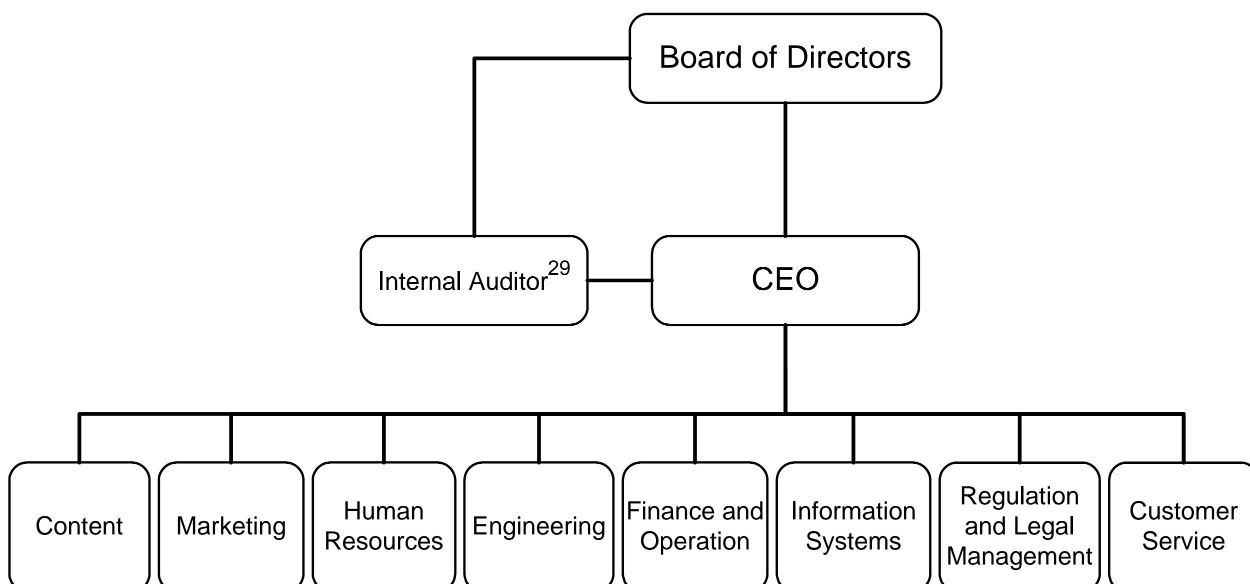
5.9.3 At present, the trend of transmitting content over non-television media creates some uncertainty as to the payment of royalties for such transfer, inter alia due to the fact that to the best of DBS's knowledge, some of the authors are not represented by the aforesaid organizations with respect to such media.

5.9.4 DBS participates, fully or partially, in investment in original productions that 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 give permits to use rights and to participate in revenues flowing from additional uses of content over and above broadcast by DBS.

5.10 Human Resources

5.10.1 <u>Organizational structure</u>

DBS has 8 departments, each one headed by a VP who is a member of management of DBS. DBS's departments are: marketing, customers (including recruitment of customers and service), content, engineering, finance and operations, human resources, regulation and legal administration, and information systems:



5.10.2 DBS personnel by division

Division	Number of Employees		
		As at December 31, 2006	As at December 31, 2007
Marketing Department		22	27
Sales Department		283	295
Customer Service		1,016	1,116
Content Department		53	60
Engineering Department		72	78
Finance and Operations Department		100	106
Human Resources Department[30]		13	39
Regulation and Legal Administration Department		2	2
Information Systems Department		55	65
Management		3	3
Total		1,619	1,971

5.10.3 Training and development of human capital

DBS provides regular training for its customer service, technical service and sales personnel, via its training center.

DBS trains some 1,000 employees every year.

5.10.4 Employee remuneration schemes

For options to officers at DBS, see also Note 26 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

Bonuses and Nature of Employment Agreements

[29] The auditor is an external auditor

[30] In January 2007, the training sections of the Company's various departments was unified into central administration as part of the Human Resources Department.

DBS employees are employed under personal employment agreements, on the basis of a monthly salary or an hourly salary (usually service representatives and telephone sales representatives). The salaries of sales personnel, service personnel and collection employees are comprised of a base salary and commissions / bonuses based on performance. The employment agreements are usually for a non-specific period, and each party may terminate the agreement by prior notice in accordance with the agreement or the law.

DBS employs people at the telephone service call center on weekly days of rest and on days of rest prescribed by the State. In March 2007, DBS filed an application for a permit for such employment for 2007. The permit has not yet been received. DBS has also filed such an application for 2008 and to the best of DBS's knowledge, this application is in the process of approval.

5.11 Raw materials and suppliers

5.11.1 Main raw materials

The main raw materials used by DBS for its broadcasting operations are:

A. Television content

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of original productions made for DBS which, under purchase agreements, may be broadcast a number of times or which may be sold to third parties are deemed to be part of DBS's broadcast rights inventory, and the cost of them is amortized over the period of their expected use, or in accordance with the estimated number of future screenings of such programs, but in any event, are amortized in full upon expiration of the broadcast rights under the contract.

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for local sport channels from these two content providers.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with two owners of the rights to the space segments (see section 5.16.2 below).

DBS is dependent on the continuing regular availability of the space segments (see section 5.20 below).

As at the date of this report, DBS pays the current rental on space segments on the Amos 1 satellite, and makes partial payments on account of the rental debt for previous periods the time for payment thereof to the Israel Aviation Industry has passed (due to assignment of the right to receive rental from HLL to the IAI). Due to arrears in payments by DBS set out in the above agreement, DBS is negotiating with the IAI due to the latter's demand to repay the entire debt. For the settlement agreement with HLL regarding the amount of the annual rental payments owing to HLL for lease of the space segments on the Amos 2 satellite, see section 5.18.8 below.

C. Digital decoders

DBS purchases digital decoders for the purpose of receiving and decoding its encrypted broadcasts at customer homes. DBS is dependent upon the suppliers from whom the decoders are purchased, including PVR decoders (ADB via Eurocom – see section 5.16.1 below, and UEC). Replacement of a decoder supplier with another supplier does not in itself entail substantial additional costs, but the replacement would require a significant preparation period to adapt the decoders of the alternative supplied to DBS' broadcasting and encryption system, which might cause DBS to lose revenues. For a description of DBS's contracts with decoder suppliers, see section 5.16.1 below.

D. Operating and encryption systems

DBS purchases from NDS services linked to the operating systems of its broadcasting setup and encryption means (see section 5.16.3 below) as well as hardware for these services. DBS is dependent upon the regular provision of these services.

5.12 Working capital

5.12.1 Customers

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2007, customer credit amounted to approximately NIS 145,524,000 net.

5.12.2 Supplier credit

The average supplier credit period in 2007 was 123 days.

5.12.3 Deficit in working capital

As at December 31, 2007, DBS's deficit in working capital amounted to NIS 1,326,750,000.

5.13 Financing

5.13.1 Average interest rate for loans

5.13.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

A. CPI-linked non -interest bearing loans.

B. CPI-linked loans bearing annual interest of 5.5%.

C. CPI-linked loans bearing annual interest of 11%.

5.13.1.2 Institutional bodies

The loans provided to DBS by institutional bodies in 2005 (see section 5.16.8 below) are linked to the consumer price index and bears interest at an annual rate of 11%.

The loans provided to DBS by institutional bodies in December 2006 and June 2007 were linked to the consumer price index and bore interest at an annual rate of 8% (these loans were fully repaid in August 2007).

Debentures (series A) of DBS (see section 5.13.8 below) are linked to the consumer price index and as at the date of this report, bear annual interest at a rate of 7.9%.

5.13.1.3 Banks

Short-term credit – the average interest rate for this credit for 2007 was 6.248%.

Long-term credit – there are two types of loans:

A. Loans based on prime interest rates where the average interest rate for 2007 was 6.577%.

B. CPI linked loans, the average interest rate for which was 6.58%.

5.13.2 Credit restrictions applicable to corporations

Under a financing agreement between DBS and a consortium of banks that provided DBS with banking finance, as re-expressed in August 2003 and amended from time to time (hereinafter: the "Finance Agreement" and the "Banks", respectively), DBS must comply with all the following financial criteria:

A. Minimum overall income.

B. Minimum operating surplus.

C. Minimum operating surplus less DBS investment in decoders and modems.

D. Maximum and minimum supplier credit.

E. Minimum targets for coverage of the bank debt and debt balances.

F. Maximum overall finance requirements.

G. Maximum churn rate.

The values for compliance with the financial criteria are variable and are measured quarterly (except for a different measure of the criterion of the maximum subscriber churn rate). Non-compliance grants the banks the right to demand early repayment of the loans and the right not to provide DBS with the balance of any unused credit line. During 2005, the banks completed providing the entire credit limit to which DBS was entitled under the financing agreement (apart from the sum of approximately half a million shekels) in return for the provision of shareholders' loans by the shareholders of DBS in the rates required under the financing agreement (apart from shareholders loans which the banks waived under the amendment to the financing agreement dated December 2005, as replaced in the schedule to the financing agreement dated May 2006 (in this section: the "**amending document**")). Under the amending document, the banks confirmed that actual investments by shareholders in DBS by the end of 2005, despite certain deficits therein compared with the values prescribed in advance in the financing agreement, do not constitute a breach of the financing agreement. Under the amending document, the bank credit limit was increased (in this section: the "**additional credit**"). Under the amending document, the additional credit is intended to be repaid by the end of 2008, in the installments set out in the amending document, however, in the event of injection of shareholders' equity into DBS by its shareholders, or external credit (in such sum and on such conditions as require receipt of the banks' consent under the financing agreement) before the date of repayment of the additional credit, DBS is required to repay the additional credit early, in the amount of the sum injected. It was further agreed that the rate of interest for the bank credit would be increased pending full payment of the additional credit.

During 2006, DBS began gradual repayment of the bank credit that it had taken, until full repayment in 2013.

In July 2007, the financing agreement was amended via an addendum to it. Under this addendum, inter alia, the financial target conditions that DBS is required to comply with as of Q2 of 2007 and until 2013 (the date of full repayment of the bank credit) were amended. The amendment also prescribed a mechanism for determining the rate of receipts of issues of debentures (series A) of DBS, including future extensions of the series, if any, to be used for repayment of the bank credit. In this regard, see also Note 13 to the Company's financial statements for the period ended December 31, 2007, which are included in this periodic report.

5.13.3 In addition to the above-mentioned financial commitments, pursuant to the Finance Agreement additional restrictions anchored therein apply to DBS, the main ones being:

A. Restrictions related to compliance with its business plan, update of such plan and dealing in operations that are not an integral part of its current operations.

B. Restrictions on the assumption of third-party liabilities, including the receiving and granting of credit.

C. Restrictions on the distribution of profits and payment of management fees or similar payments to shareholders.

D. Restrictions on the creation of pledges and sale of certain assets without consent from the banks.

E. Restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures).

F. Restrictions with respect to the shareholders' loans provided to DBS by the Company, including the inferiority thereof to the bank credit (and debentures that are to be issued to the public, if any), and restrictions relating to the repayment thereof prior to repayment of the bank credit in full, except with respect to shareholders' loans provided by the shareholders of DBS after April 1, 2004, which DBS may repay on account thereof prior to repayment of the full bank credit, on the conditions set out in the financing agreement (DBS and the banks have agreed that they will view the loans received by DBS from institutional bodies in 2005 (see section 5.16.8 below) as being part of the aforesaid shareholders' loans, and accordingly, DBS may repay them under certain restrictions as set out in the financing agreement, prior to full repayment of the bank credit).

G. Restrictions with respect to the issue of shares of other securities of DBS without the consent of the banks, with the exception of issue of securities to shareholders of DBS permitted subject to the conditions set out in the financing agreement.

DBS is bound by mandatory repayment of sums that it receives with respect to the placements of shares or debentures to the public, sale or transfer of property and certain cash surpluses of DBS, on the conditions and at the rates set out in the financing agreement. DBS may, voluntarily, effect early repayment sums received with respect to placements of shares or debentures to the public, which may remain after the aforesaid mandatory repayment, on such conditions and at such rates as are set out in the financing agreement.

The financing agreement also sets out provisions regarding various reports which DBS is required to provide to the banks, including with respect to examination of its compliance with financial conditions.

The financing agreement sets out a list of events which amount to breach thereof, and which entitle the banks, under the conditions set out in the financing agreement, to make the bank credit immediately repayable.

5.13.4 DBS has taken a floating charge in favor of the banks, and has taken out fixed charges in favor of the banks over its rights under substantial agreements to which it is a party, over its unissued registered capital, over its goodwill, over 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 broadcast license).

5.13.5 The shareholders of DBS, with the exception of the Company, have charged the DBS shares that they hold in favor of the banks, in assurance of the sums that the banks provided and will provide to DBS. Most of the shareholders also charged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that pending repayment of the full bank credit, the shareholders' loans would be inferior to the bank credit, that they would not effect dispossession of them and that they would not require that they be paid back nor any security in assurance of them. In view of the restrictions on the Company's ability to charge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Note 19 to the Company's financial statements for the year ended December 31, 2007, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders charged in their favor. The Company also gave an undertaking to sell its shares if the shares charged by the banks are sold. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks inter alia not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

5.13.6 As at the date of this report, DBS is not in compliance with all of its undertakings under the financing agreement to take out insurance with respect to its operations and assets, including with respect to the duty to take out satellite failure insurance for the satellites on which DBS leases space segments for the purpose of its broadcasts. DBS is negotiating with the banks for relief with respect to its insurance undertakings, which will enable it to comply with these undertakings.

In addition, arrears in DBS's payments to the Israel Aviation Industry (as set out in section 5.11.1B above), constitutes a prima facie breach of the financing agreement, however, the banks have allowed DBS not to deem the demand by IAI for repayment of the debt, and non-payment of the debt, as a breach by DBS of the financing agreement, provided that by December 31, 2008, the parties reach a written arrangement regarding repayment of such debt, and that during the period prior to the aforesaid date, IAI does not institute any measures for collecting its debt as aforesaid.

In light of the forecasts of DBS management regarding the business results for 2008, DBS made a request of the banks to plan and adjust the financial commitment targets for 2008 so as to match its budget. During March 2008, consent was received from the banks to amend these commitment targets.

In the assessment of DBS' management, the sources of funding available to it will be sufficient for its needs for activities in the coming year, in accordance with the cash flow forecasts approved by the board of directors of DBS. If additional sources are required in order to meet the needs of operations for the coming year, DBS shall adapt its operations so as not to require additional sources above those available to it.

As at December 31, 2007, DBS was in compliance with the financial commitments under the financing agreement (following relief that it received from the banks in March 2008) with respect to the targets of a number of financial commitments as at December 31, 2007. In light of the fact that this relief was given after the balance sheet date, the loans from the banks are presented as part of short term liabilities.

5.13.7 **Credit amounts received in 2007**

In 2007, DBS received a bridging loan in the sum (principal) of NIS 50 million from a number of related institutional bodies who had provided it with a previous loan in December 2006. The loan (including the bridging loan) was paid back in full in August 2007.

For the loan received by DBS as part of a private placement of debentures, see section 5.13.8 below.

5.13.8 **Private issue of debentures**

In July 2007, DBS raised the sum of approximately NIS 620 million as part of a private issue to institutional investors of registered Debentures (Series A) which were listed on TACT Institutional at TASE (the "**Debentures**"). For the purpose of this issue, the Debentures were rated by Maalot the Israel Securities Rating Company Ltd. which, to the best of DBS's knowledge, has changed its name to Standard & Poors Maalot Ltd. (hereinafter: "Maalot") as BBB- / stable.

The Debentures are to be repaid in eight annual principal payments, in the months of July 2010-2017, the principal payments in each of the years 2010-2013 being at a rate of 8% of the par value of the Debentures, and the principal payments in the rest of the years 2014-2017 being at a rate of 17% of the par value of the Debentures. The Debentures are linked to the consumer price index as of the index for the month of June 2007, and bear annual linked interest at a rate of 7.9% per annum (subject to various possible adjustments in accordance with the conditions of the Debentures) which shall be paid in half-yearly installments in the months of January through July of each of the years 2009-2017. DBS has not undertaken to list the Debentures for trading on TASE, however, in the event of listing of the Debentures for trading on TASE, the annual interest to be paid on them as of such date shall be reduced to 7.4%. On the other hand, if the Debentures are not listed for trading on the Stock Exchange by July 31, 2008, the annual interest rate paid on them shall increase to 8.4% for so long as such listing does not take place (and in the event of later listing, the interest rate will be decreased from that point to 7.4% as aforesaid). If the rating of the Debentures falls by two rating points without the Debentures being listed for trading, then the annual interest rate shall be increased to 8% until the original rating is regained or the Debentures are listed for trading (in which case, the interest rate will again be decreased as referred to above). In addition, if DBS does not comply with the financial

commitments set out in the financing agreement between it and the banks, and as a condition of the banks' waiver of such breach, DBS shall undertake to pay the banks a supplement on the bank credit margin to the banks, and if at that time the Debentures are not listed for trading, then so long as it pays the banks the supplement on the bank credit margin as aforesaid and the Debentures are not listed for trading, DBS shall pay the debenture holders an annual interest supplement in the same amount.

Additional provisions have also been made in the Debentures, including with respect to payments related to them, dates of payment, and the method of convening of general meetings of Debenture holders.

With respect to the issue of the Debentures, DBS and Hermetic Trusts (1975) Ltd. (hereinafter: the "**Trustee**") executed a deed of trust in July 2007 (for the main points of the deed of trust, see section 5.16.6 below).

The Debentures are secured by a first degree floating charge, unlimited as to sum, over all of DBS's assets (apart from exceptions stemming from the provisions of the Communications Law) created by DBS in favor of the Trustee, including a condition restricting the creation of additional charges (apart from charges and actions during the ordinary course of business and charges and actions permitted under the deed of trust) and a first degree fixed charge, unlimited as to sum, over the rights and assets of DBS, charged by it in favor of the banks (apart from exceptions stemming from the provisions of the Communications Law) (hereinafter: the "**Trustee's Guarantees**"). The Trustee's Guarantees are ranked first and equal (pari passu) to the floating charges and fixed charge created by DBS in favor of the banks, in assurance of the bank credit (hereinafter: the "**Banks' Guarantees**"), without taking into account the dates of creation of the various guarantees and/or the dates of registration of such with the Companies Registrar and/or the Registrar of Pledges. The creation of other charges by DBS in favor of the banks shall be subject to the consent of the Trustee, unless such charges are also registered in favor of the Trustee. In the event of exercise of the Trustee's Guarantees and/or the Banks' Guarantees and/or exercise of the assets the subject of such guarantees, including by the holders of other securities who may be given a charge over such assets, the proceeds of exercise shall be distributed pro rata between the Trustee, the Banks and the aforesaid holders, and each chargee shall receive its proportionate share of the proceeds, equal to its proportionate share of the debt to it (as defined in the deed of trust) divided by the total debt secured by such assets.

For the purpose of rating the debentures, DBS has undertaken to Maalot (and to it alone) that it shall not make payment on account of the shareholders loan prior to the end of the life of the Debentures.

Since issues of debentures by DBS require the consent of the banks, the banks' consent to the issue has been obtained, subject to the conditions set out in the deed of consent of the banks, including conditions regarding the division of guarantees between the Trustee and the banks, and the division of receipts of the exercise thereof, if exercised. The consideration for the issue of the Debentures has been used by DBS in partial repayment of the long-term bank credit, for early repayment of the loan taken by DBS from a number of related institutional entities in 2006 (including a bridging loan provided by such entity to DBS in June 2007) in the total sum (principal) of NIS 100 million, and shall be used for DBS's current operations.

In October 2007, Maalot gave notice that the rating of the Debenture is on the watch list due to interferences in DBS's transmissions (see section 5.20 below), due, in its opinion, to the fact that such disturbances caused higher expenses than expected, to deviations from DBS's business plan and to the filing of a number of lawsuits against it. In February 2008, Maalot informed DBS that DBS had been taken off the above watchlist, and that the debentures were rated at stable / BBB-, inter alia because DBS was able to maintain its subscriber base and to meet the subscription target that it had set for itself prior to the disturbances.

On October 21, 2007, DBS received a letter from the Trustee of the Debentures stating that following interruptions in transmissions and various items published regarding that, including regarding a reduction in the number of DBS subscribers, and regarding the compensation that DBS would grant its subscribers, it wished to receive various documents and certificates from DBS in order to clarify whether the aforesaid events and their long-term impacts might harm DBS's undertakings to the debenture holders. In the assessment

of management of DBS, based on conversations with the Trustee, in light of its being taken off the watch list, the Trustee is not expected to require further particulars beyond the ordinary reporting requirements under the deed of trust.

For further details about this placement, see Note 13 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

5.13.9 <u>The Corporation's credit facility</u>

DBS's credit line is approximately NIS 974 million. As at December 31, 2007, DBS had used approximately NIS 933 million of this line of credit.

For the position taken by the Ministry of Communications regarding limitations on provision of shareholders loans by the Company to DBS, see Note 33 to the Company's financial statements for the year ended December 31, 2007, included in this periodic report.

5.14 Taxation

See Note 8 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

Assessments were issued to DBS for 2000-2004, under which the losses for tax purposes carried forward to subsequent years were reduced by 21 million, pre-business expenses from 2000 will amount to NIS 83 million and will be recognized over 10 years, and expenses in the sum of NIS 162 million recognized in previous years will be deferred to subsequent years.

During the report year, DBS reached an arrangement with the Taxation Authority with respect to deduction assessments for 2002-2004.

5.15 Restrictions on and Supervision of the Corporation

5.15.1 <u>Subjection of activities to specific laws</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 substantial impact on DBS and its operations. Likewise, legislation and secondary legislation in the field of communications in general has a substantial impact on DBS.

Restrictions are applicable to DBS by virtue of the Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations, 5758-1998 (hereinafter: the "License Regulations"), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee during the term of the license. The License Regulations prescribe, *inter alia*, suitability conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

The Telecommunications (Television Broadcasts via Satellite) (License Fee and Royalties) Regulations, 5759-1999 (hereinafter: the "**Royalty Regulations**") as amended in August 2006, provide the rate of royalties and the broadcast license fees to be paid by a licensee for satellite broadcasts to the State. Under those regulations, DBS owes royalties in a rate of 3.5% of its revenues from the provision of broadcasting services in the years 2004 and 2005, in the rate of 3% for 2006 and in a rate of 2.5% for 2007. The royalty rate will be 2% in 2008, 1.5% in 2009 and 1% from 2010 onwards. In February 2008, an agreement was signed between DBS and the State regarding the spreading of payment royalty sums under which DBS undertakes that the sum of royalties for the period commencing in July 2007 and ending in September 2008 (but not more than the sum set out in the Agreement), plus interest differentials, would be paid in 11 monthly installments commencing in February 2009.

Under Section 6WW of the Communications Law, the license may prescribe the maximum prices that a subscriber may be billed. As at the date of this report, no such prices have been prescribed.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, from 2004 to 2008 (inclusive), each year DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees. Pursuant to the Council's confirmation, DBS was in compliance with its original production obligation for 2006 (including the proportionate part of completing past debts) apart from non-substantial deviations in the sub-division into various kinds.

Under the requirements of the law and the license, DBS is required to allow independent channel producers under section 6EEE of the Communications Law to make use of its infrastructure in order to distribute transmissions to its subscribers, in return for payment to be set out in an agreement, and in the absence of any agreement, in consideration for payment to be prescribed by the Minister, upon consultation with the Council.

5.15.2 Operations subject to broadcasting license

DBS's operations are subject to the provisions of its broadcasting license. The Communications Law, the License Regulations and the broadcast license stipulate a number of grounds on the basis of which the Minister of Communications can terminate, restrict or make the broadcasting license conditional, after consultation with the Council and the granting of a hearing to the broadcasting licensee, among them, violation of the provisions of the law or rules and regulations pursuant thereto, a material violation of the terms of the broadcasting license or a non-material violation which was not amended after a warning from the Minister or the Council, the cessation of broadcasts for an unreasonable period of time or the total cessation of broadcasts for 14 consecutive days, noncompliance of the licensee with the restrictions determined in relation thereto in the License Regulations, and the appointment of a receiver or temporary liquidator for the licensee or the issuing of a liquidation order, all pertaining to the licensee.

The Minister of Communications, in consultation with the Council, and after granting the broadcasting licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, *inter alia*, for the purpose of the goals stipulated in the license. In addition, the Council alone has concurrent authority to amend the broadcasting license, provided that the broadcast licensee is first of all given an opportunity to make claims.

5.15.3 Principal restrictions by virtue of the law and broadcasting license

The Communications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards, which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation (in this respect DBS received the consent of the Ministry of Communications for a charge that DBS sought to create inter alia over the "license assets" in favor of the trustee for the debenture holders); an encumbrance placed on any of the broadcasting license's assets shall only be exercised in the manner prescribed by the Minister of Communications; DBS's broadcasts to be in accordance with the broadcast license and their scope subject to the provisions of the law; a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more or in any percentage resulting in a person becoming an interested party or controlling party of the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to those shares that are listed on the Stock Exchange); reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the cable companies) except for the

transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts, under restrictions prescribed by the Council.

The broadcasting license also contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications; conditions regarding whether the terminal equipment installed by DBS complies with standards.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The licensee is under an obligation to give notice in writing to the chairman of the Council of any change in the price list approved by the Council immediately upon publication of such or upon notice of a change to subscribers, whichever is the earlier, and the chairman may, if he is of the opinion that such change might cause harm to competition, misleading of the public, discrimination among subscribers, unfair competition, or that it does not comply with the provisions of the law, the regulations, the rules, the license or the Council's policy, instruct the licensee not to change the price list or given notice that he intends to place the change before the Council for discussion. If the chairman does not give the licensee notice as aforesaid prior to the date of commencement of the change, the change shall come into force. With respect to reductions, discounts and promotions (for a restricted period), DBS is required to notify the chair of the Council no later than the date of publication or commencement, whichever is the earlier, and the chair may intervene if he finds them to be misleading to the public or as drawing distinctions between subscribers. DBS must give notice to its subscribers of termination of any special offer under which they joined DBS, at least 14 days in advance.

The broadcasting license sets out a number of provisions that relate to the content of DBS's broadcasts, including approval of the channels broadcast by DBS and amendments in respect of them by the Council (including the content of DBS's basic package), approval of the electronic program guide (EPG) which is part of DBS's digital service to its subscribers and approval of pay per view broadcasts.

DBS is also required to transmit the television and radio (FM) channels broadcast nationally in Israel including the educational television channel and "must carry" broadcasts to its subscribers. Under the provisions of the law, DBS currently transmits the broadcasts of two special channels, the Music Channel ("Music 24") and a Russian language channel ("Israel Plus"), in consideration for a payment which the Minister is required to prescribe. As at the date of this report, no fixed payment has yet been prescribed for the transmission of those special channels. DBS as the aforesaid special channels are in legal proceedings with respect to the debt for the transmission fee that DBS is claiming from the channels, including with respect to the Minister's power to require them to pay such a transmission fee.

To the best of DBS's knowledge, the Council is considering publishing tenders for the grant of licenses to additional special channels – both an Arabic language channel and a heritage channel.

Pursuant to a decision of the Council dated March 2006, DBS, including its shareholders, are entitled to own up to 30% of the local channels broadcast in DBS's broadcasts (compared with a 20% restriction that applies to the cable company). As at the date of this report, this restriction is being kept with respect to DBS's channels.

In 2001, the Ministry of Communications issued administrative orders regulating the method of transferring subscribers from the services of the cable company to DBS and vice versa, and use of the infrastructure installed in the subscriber's home (the "administrative orders"). The administrative orders also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider.

Since entry into force of the administrative orders, the cable company has made claims against DBS to the effect that it is in breach of the administrative orders. DBS for its part has made claims to both the Ministry of Communications and to the cable company regarding breach of the administrative orders by the cable company.

In 2004, the Ministry of Communications gave notice to DBS that in light of the extent of its breaches of the administrative orders, it intended to issue a demand to DBS to pay financial sanctions for some of the breaches that it had committed, in the sum total of approximately NIS 1.4 million. DBS objected to the imposition of the aforesaid financial sanctions, and to date no such letter of demand has been received.

On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable company that in light of their many breaches of the administrative orders, it has examined the issue and is currently considering repealing them *inter alia* in light of the mechanism for purchasing wiring set out in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120. On November 2, 2005, DBS submitted its position to the Ministry of Communications to the effect that the administrative orders should remain in force, whilst repealing the prior notice obligations set out therein which require the giving of notice to the party whose subscribers are disconnecting from their service. DBS also claimed that the statutory provision affording title to the multi-channel television provider over the infrastructure installed by it in the subscriber's home should also be repealed. DBS claimed that at least, if this provision is to remain, then the proper interpretation of it ought not be to give the cable company title to the wiring installed by them in private homes. DBS also claimed that the sum prescribed in the law as the consideration payable for purchase of the wiring (NIS 120) is baseless and that should such prescription remain in force, it should be substantially reduced. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and contains many defects which will prevent proper transfer of subscribers under it, and will prejudice competition. As at the date of this report, the results of the hearing have not yet been reported.

At the beginning of March 2006, the cable company gave notice to the director general of the Ministry of Communications that in light of DBS's breaches of the administrative order, it was ceasing to accept disconnection notices sent to it by DBS, and indeed, the cable company ceased accepting any notices under the administrative order, including connection plans and termination notices. DBS dismissed the claims made by the cable company and argued that by refusing to receive notices from DBS, not only was the cable company in breach of the administrative order, it was also in breach of its license and of the agreements via which it had contracted with its customers, since it continued charging subscribers a subscription fee despite knowing that such subscribers had disconnected from their broadcasts. DBS also demanded that the Ministry of Communications order the cable company to stop charging subscribers immediately upon receipt of notice of disconnection. As at the present date, the Ministry of Communications has not yet commented on the issue, and the cable company continues not to accept notices from DBS.

In the assessment of management of DBS, if the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the transition of subscribers between the various suppliers.

5.16 Substantial agreements

Following is a summary description of the principal agreements likely to be considered as material agreements not in the normal course of business of DBS which have been signed and/or are valid in the period of the Periodic Report:

5.16.1 Agreements for the purchase of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: "ADB") and Eurocom Marketing (1986) Ltd. (hereinafter in this section: "Eurocom") in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the "**ADB Agreement**"). Under the ADB Agreement, DBS purchased a minimum number of decoders from ADB and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS is to send to Eurocom. DBS is also responsible for the converters and support

service thereof via Eurocom. In 2007, DBS purchased decoders from Eurocom in the total sum of approximately NIS 33.6 million. As at the date of these statements, DBS has ordered more decoders under the ADB agreement. Following the assignment of ADB's rights and obligations under the ADB Agreement to another corporation, Advanced Digital Broadcast S.A., it was agreed at the beginning of 2008 that an addendum would be drafted to the ADB Agreement, governing such assignment and making certain amendments to the ADB Agreement. In addition, at the beginning of 2008, Yes obtained an understanding to extend the term of liability with respect to a particular series of decoders. As at the date of this report, these arrangements have not yet been signed.

In 2007, DBS purchased decoders from ADB which enable viewing using HD technology. DBS has also recently ordered PVR decoders which will enable viewing HD broadcasts.

For the legal proceedings regarding the deficit demand from the Customs Department of the Taxation Authority for decoders purchased by DBS from Eurocom and smart cards imported by Eurocom for DBS, see section 5.18.7 below.

Purchase of PVR decoders – in July 2004, DBS entered into a contract with UEC Technologies (Pty) Limited (hereinafter: "UEC") for the development, manufacture and supply of PVR decoders. The agreement is for 5 years, automatically renewing for additional terms of one year each, unless one of the parties gives notice otherwise. UEC supplies the Company with support services, including a local repairs laboratory, with respect to reasonable changes, as may be made from time to time, in development of the software, for no additional consideration, but subject to an agreed ceiling of changes each year, the warranty term for the decoders so supplied being 24 months with the exception of the device's hard disk which has a 15 month warranty, special provisions having been made with respect to substantial system failure.

5.16.2 <u>Space segment lease agreements</u>

<u>First space agreement</u>

In order to transmit the satellite broadcasts DBS signed an agreement in April 1999 with the HLL Communications Ltd. (hereinafter: "HLL"), in which there is an interested party which is also an interested party in DBS, and with Israel Aircraft Industries for the leasing of space segments in the Amos 1 satellite as amended in May 2003 (hereinafter: the "First Space Agreement"). The lease period determined in the First Space Agreement will conclude on June 30, 2009 (in relation to the period from January 1, 2009 – subject to the purchase by DBS of insurance cover as defined in the agreement) or upon the end of the life of the Amos I satellite, the earlier of the two, and if DBS continues to use the space segments after the end of the lease period, it shall continue to pay the leasing fees. DBS has undertaking to lease at least 8 space segments on the satellite. According to information provided to DBS by Israel Aviation Industries (IAI), the Amos 1 satellite is not expected to stop operations before June 2008, the estimated time of termination of operations is during September 2008. These assessments by IAI are forward-looking information based, to the best of DBS's knowledge, on calculations that IAI has done, in accordance with various technical parameters. However, technical failures and other events might also affect the life-span of the satellite.

The rental set out in the First Space Agreement is made up of annual rental for each space segment which DBS uses.

The First Space Agreement regulated mechanisms guaranteeing reserve and backup in the event of satellite faults. *Inter alia*, it was prescribed that the satellite's reserve transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault contemporaneous with another capacity DBS has priority for the restoration of the capacity that it has leased.

As at the date of publication of this periodic report, DBS has not completed the reduction of its past debt as required under the amendment to the agreement of May 2003.

<u>Second Space Agreement</u>

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (hereinafter: the "Second Space Agreement"),

whereby DBS is to lease no fewer than 12 space segments on the two satellites (of which 8 on Amos 1) from HLL, and one year later, shall lease two additional segments on Amos 2 on the same polarity, so there will be no need to adjust DBS's receiver dishes. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, the earlier of the two. The consideration for the lease determined in the Second Space Agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments which DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the Second Space Agreement will lease on the Amos 2 satellite. The Second Space Agreement brings together space segments which are to be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

HLL has undertaken to act to extend the lease period for the space segments beyond the current lease period, and for this purpose to endeavor to station a subsequent satellite in a suitable position, with similar technical characteristics, so that it will not be necessary to make changes to the receiver systems of DBS subscribers, under the conditions determined in the agreement, until December 31, 2013, provided that an appropriate agreement for the continuation of the satellite's life is signed by the parties, as shall be determined in said agreement, pursuant to which DBS will lease at least 14 space segments in consideration of annual leasing fees under similar commercial conditions.

As at the date of this report, DBS leases 7 space segments on the Amos 1 satellite, due to a technical restriction which prevented leasing of the eighth segment for a very long period, which required DBS to implement alternative permanent solutions. DBS held negotiations with IAI regarding the obligation to lease the eighth segment, and the cost thereof. In fact, as at the date of the report, IAI is not charging DBS for lease of the eighth segment. As at the date of this report, DBS is also leasing 6 space segments on the Amos 2 satellite. The rental in 2007 for the First Space Agreement and the Second Space Agreement amounted to approximately NIS 108,987,000. For the financial dispute with HLL see section 5.11.1B above.

5.16.3 <u>Information and encryption system development agreement</u>

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "NDS") for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. The provisions of the agreement were applied in January 2006, *mutatis mutandis*, to the advanced (second generation) version of the smart card. DBS has also entered into a number of agreements with NDS for the development and implementation of a system of applications to enable DBS to offer its subscribers interactive services and VOD services. DBS is paying for NDS's services and products based mainly on the number of decoders that it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber services, the granting of usage licenses for these applications and the development of future interactive technological services.

5.16.4 <u>Telephone Call Center Service Agreement</u>

DBS operates some of its telephone call centers via Bezeq Online Ltd. (hereinafter: "Bezeq Online"), a wholly owned subsidiary of the Company, which employs staff who serve as

service representatives for DBS, under an agreement of June 2001. Under the agreement, DBS purchases call center services from Bezeq Online. The agreement is for a period of 3 years, and is automatically extended annually for a further period of one year, unless one of the parties gives notice otherwise.

Pursuant to the agreement, Bezeq Online itself operates a sales center, employs staff which serve as service representatives at the call center operated by DBS, and supplies technical support and maintenance services to certain of DBS's systems. In consideration for Bezeq Online's services, consideration is paid based on the cost of employment of the employees at the call centers, and various additional costs set out in the agreement.

5.16.5 Finance agreement with the banks

For a summary of the main points of the agreement, see section 5.13 above and Note 13 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

5.16.6 Deed of Trust relating to Debentures (Series A)

With respect to the issue of the Debentures (Series A) of DBS, a deed of trust was signed in July 2007 between DBS and the Trustee. The deed makes various provisions regarding the relationship between DBS and the holders of the Debentures (via the Trustee) including with respect to the possibility that DBS might increase the Debenture series and issue additional debentures and/or securities. A restriction is also prescribed depending on DBS's EBITDA with respect to DBS's right to register first degree charges in favor of the holders of additional securities as aforesaid, and/or allow them to participate in charges in favor of the Trustee, without requiring the Trustee's consent.

The deed of trust sets out various events, the occurrence of which requires the Trustee to convene a meeting of holders of the Debentures, in which, if the event has not yet been dealt with, the holders may decide, in a resolution requiring a 75% majority of the Debenture holders represented at the vote, to make the Debentures immediately repayable (in which case, the Trustee must exercise the securities granted to it) the events including: non-payment of a sum owed by DBS on time after a warning period; appointment of a temporary liquidator, temporary or permanent receiver to DBS and/or over all or most of DBS's assets, the passing of a winding up resolution by DBS (except for winding up for the purpose of merger with another company and/or a restructuring of DBS), institution of proceedings against DBS under section 350 of the Companies Law or grant of an order under such provision, and the imposition of attachment orders or certain acts in execution of judgment, not cancelled within the periods set out in the deed; exercise of the banks' guarantees (as defined in section 5.13.8 below) or exercise of charges over most of DBS's assets by third parties; the making of another series of debentures issued by DBS immediately repayable, if the balance to be paid out is greater than the sum set out in the deed; termination of DBS' business or an intention so to do, and the creation of circumstances giving rise to a real probability that DBS will cease paying its debts or running its business; cessation of rating of the Debentures by any rating company for the period and under the conditions set out in the deed (so long as DBS is not a reporting corporation under the Securities Law); and if DBS breaches or does not fulfill any substantial condition or undertaking included in the Debenture or the deed of trust (except for non-payment as aforesaid) which the Trustee may deem to be harmful to the rights of the holders of the Debentures, and such breach is not remedied within the warning period set out in the deed.

DBS has also undertaken under the deed of trust to do various acts and to issue various documents and consents to the Trustee and/or provide access to DBS' information and documents, in the events and under the conditions set out in the deed of trust.

For the principal conditions of the Debentures and the securities created by DBS under the deed of trust, see section 5.13.8 above.

5.16.7 Agreements with DBS shareholders – see section 5.13.3F above

5.16.8 Agreements with Institutional Bodies

According to agreements of March and April 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. This credit was taken on inferior terms with respect to payment,

compared with the bank credit, with exceptions similar to those that apply to shareholders' loans provided by the shareholders of DBS. After April 1, 2004, these loans were received under three different loan agreements between DBS, the Company and each of the institutional bodies, and in assurance of repayment of the 2005 institutional loans, the Company gave an undertaking to pay sums on account of the loans the amount of which is to be set based on the formula set out in the agreements (which is conditional, inter alia, on the value of DBS's debts), as set out in Note 13 to the financial statements of the Company for the year ended December 31, 2007. The lenders, the Company and the banks agreed that in the event of exercise of the Company's guarantee to the banks (see section 5.13.5 above), the lenders shall be entitled (each pro rata their share) to a proportionate share of the exercise receipts, at the rate set out in the agreements.

5.17 Joint venture agreements

5.17.1 DBS purchases annual internet access packages at high baud rates based on DSL infrastructure, and sells these packages to its subscribers non-exclusively (see section 5.6.5 above).

5.17.2 DBS has a joint venture with Bezeq International Ltd., a subsidiary of the Company, for the supply of a basket of services including multi-channel television services (supplied by DBS), infrastructure connection to the internet and internet access services (supplied by Bezeq International Ltd.). The joint venture operates under the brand name "yes-Wow". Since 2005, the joint venture has been operating to retain customers only, and no marketing or sales efforts have been made.

Under the venture, each party bears its own expenses (i.e. Bezeq International Ltd. re all matters relating to internet access services and DBS regarding all matters relating to multi-channel television services).

5.17.3 DBS and Microsoft Israel Ltd. (hereinafter: "Microsoft") are setting up a marketing and technical joint venture with respect to a media center system which is a system that includes software components and mostly also content which enables the viewing, on television screens, of video content transmitted to the viewer via the internet, and content saved at the viewer's home. As part of this joint venture, the media center will interface with DBS's website and it shall be possible to view DBS's contents as transmitted using Broadband TV technology.

5.17.4 For the joint venture between DBS and Walla! Communications Ltd. with respect to the website, see section 5.4.3 above.

5.18 Legal Proceedings

5.18.1 On July 6, 2005, DBS submitted a statement of claim in the District Court at Tel Aviv against Pace Micro Technology Plc., in which DBS requested that the court require the defendant to pay the direct costs that DBS incurred in order to fix defective decoders of a particular model assembled and/or manufactured by the defendant and supplied to DBS in 2000-2001. Under the statement of claim, the decoders suffered from three serial hardware faults which were under the defendant's liability and which caused DBS severe damages, mainly due to the need to repair them and to bear the costs involved in such. The claim is for the sum of approximately NIS 31.4 million, and is based on various causes of action including breach of framework agreement by the defendant, negligence against DBS and breach of the provisions of law, DBS retaining its right to sue for additional damages. On July 15, 2007, a statement of defense was filed by the defendant together with a statement of counter-claim against DBS and Eurocom Digital Communications Ltd. (in this section: "Eurocom"), jointly and severally, relating to a monetary claim in the sum of NIS 42,640,000. Under the statement of defense and statement of counter claim, the defendant claims that the liability for the faults in the decoders does not fall on it but rather, falls on DBS and/or on Eurocom Communications, due, in its view, inter alia to the fact that the decoders were not properly characterized by the counter defendants, were not properly checked by the counter defendants and the decoders, at least in part, had not been properly installed on the premises of DBS's subscribers by DBS or contractors working for it. In light of these and other claims, according to the statement of counter-claim, the defendant suffered, in its view, various kinds of damage relating to the need to repair the decoders even after the warranty period under the contract, to provide spare parts, to provide human resources services and various payments that the defendant alleges to have made to Eurocom

Communications. Alternatively, the defendant claims loss expenses and loss of profits caused to it, it alleges, due to the acts and omissions of DBS and/or Eurocom, in the sum of USD 15,000,000. For fee purposes, the claim was set at the sum of NIS 42,640,000. Pursuant to a ruling of the court, as amended at the defendant's request (to which DBS did not object), all of the preliminary proceedings are to be completed within 30 days of the date of submission of the last pleadings. Pursuant to procedural agreements between the parties, DBS was required to submit its pleadings by November 23, 2007 (in accordance with an extension given to Eurocom), and the statement of response from the defendant to the statement of counter defense by DBS is to be filed 45 days after the filing of such statement of defense. On November 1, 2007, DBS filed an application for an order to amend the statement of defense and statement of counter claim filed by the defendant, due to failure to comply with the Civil Procedure Regulations. At the same time, DBS also filed an application to postpone the date of submission of the statement of response and statement of defense in the counter claim by DBS pending ruling on the application to award the aforesaid order. On November 18, 2007, the defendant filed an application to strike out the claim, alleging that the fee paid in the file was insufficient due to the contradictions that the defendant claimed were in the statement of claim. On December 9, 2007, DBS filed an objection to the application to strike, and later, pursuant to the ruling of the court, the state attorney's office response to the application was also filed, leaving the ruling to the court's discretion. Rulings have not yet been handed down in these applications. A hearing (pre-trial) in this file has been set down for July 2008).

5.18.2 In May 2007, a claim filed against DBS in the District Court at Haifa by Al Jazeera Satellite Network Co., which included a monetary claim in the sum of NIS 3,000,000 (for fee purposes) and an application for an injunction to prevent DBS from broadcasting or making use of the channel produced by the plaintiff, was withdrawn by consent. The claim was struck out in accordance with a memorandum of understanding under which the channel would continue to be broadcast on the conditions agreed upon by the parties.

5.18.3 In September 2007, a petition by DBS against the Minister of Communications regarding decisions of Ministers of Communications dated December 31, 2004 and February 14, 2005 relating to the amount of money injected into DBS by its shareholders and external financiers was struck out in limine for want of clean hands.

5.18.4 On November 6, 2006, an application was filed with the District Court at Tel Aviv to approve a class action against DBS. The claim and the application stated that DBS had not, as it were, returned the full sums owing to the Applicant and to other subscribers who chose to terminate their contract with it, out of the deposit given by them as security in return for terminal equipment lent to subscribers. The Applicant did not set out the total damage of the members of the group, on the grounds that such data was in the possession of DBS. In her view, the damage caused to her as at the date of filing of the claim is NIS 546.74 and she assesses the cumulative damage of members of the group at more than NIS 16 million. Under the procedural arrangement reached by the parties, DBS filed its response to the application for approval on February 13, 2007, and the applicant's response was given on October 15, 2007. The Attorney-General's position has not yet been submitted. On October 21, 2007, the applicant filed an application to summon witnesses, which was accepted by the court on October 22, 2007 ex parte. On October 25, 2007, DBS filed an urgent application to cancel the ruling handed down ex parte and on October 28, 2007, the court decided to stay the aforesaid ruling. On December 24, 2007, a pre-trial hearing was held at the end of which, an evidence session was set down for March 24, 2008, for the cross-examination of the persons giving affidavits. During the pre-trial session, the court proposed that the parties consider the option of a settlement.

5.18.5 On January 5, 2005, DBS filed a claim in the Local Court at Tel Aviv against a company and two of its subscribers following information that it had received that the broadcasts of channels 5+ and Tchelet, originally produced by it, were being transmitted on the internal cable network of the town of Efrata in Samaria [sic – it's in Judea], and were being received in all of the homes of that town that were connected to such cable network. Investigations by DBS showed that the channels' transmissions were being received via two decoders which contained DBS smart cards, and that those decoders were decoders that had been given to the defendants. It also became apparent that transmission of the broadcasts of the channels in the town was being done via the broadcast center operated by the defendants in the town. DBS demanded to charge the defendants to pay compensation in the sum of NIS 2,000,000 for filing fee purposes, and in addition, DBS petitioned for a declaratory order to the effect that the Defendants had breached DBS's rights under the

Copyright Ordinance. Since liquidation orders and receivership orders were issued against the two defendants in the file, and in light of information regarding the poor financial situation of the remaining defendant in the file, DBS decided to withdraw the claim. On August 9, 2006, DBS filed a debt claim in the sum of NIS 27,200,000 to the Official Receiver for the debt of one of the defendants. On July 19, 2007, DBS submitted closing statements in the debt claim to the special manager appointed by the Official Receiver.

5.18.6 On December 3, 2002, an application to approve the filing of a class action was filed with the District Court against DBS, the Cable and Satellite Broadcasts Council and the Ministry of Communications with respect to the broadcasts of the sports channel 5+ (hereinafter – the 'approval application'). According to the applicants, the broadcast of channel 5+ contravenes the conditions set out in the Council's approval of broadcast of it, and divest channel 5 of content, in contravention of the provisions of the said conditions. On November 9, 2006, a settlement was signed between the plaintiffs and DBS, under which DBS undertook to broadcast various sports transmissions as part of Channel 5, for one full season of the relevant sporting areas, during the years 2006/2007, and other sporting areas during 2007/2008. The settlement was filed with the court on November 11, 2006. The settlement left the issue of costs and attorneys' fees to the discretion of the court and these were ruled in favor of the plaintiff. On November 30, 2006, two opinions were filed with the court on behalf of the plaintiffs: One related to the value of the benefit granted to subscribers of the cable and satellite companies under the settlement; and the other related to the rate of the fees of the attorney representing the class plaintiff. According to the first opinion, the value of the benefit granted to the subscribers of both of these companies under the settlement is between NIS 90 and 97 million, the value of the benefit to DBS's subscribers alone being between NIS 28 and 30 million. Under the second opinion, the remuneration to the class plaintiff should be the equivalent of approximately 6% of the value of the benefit, and the costs of counsel must be equal to approximately 12.5% of the value of the benefit. On January 4, 2007, DBS and the cable companies filed an expert opinion on their behalf with the court, with respect to the value of the benefit granted under the settlement, and an application for an order regarding the methods of filing evidence containing commercial secrets, to which a confidential affidavit by the producers of the Sports Channels was attached, setting out the structure of the costs of the Sport 5+ Channel. According to this opinion, the remuneration to the class plaintiff and the fees of his attorneys should be derived from the benefit value of NIS 4.6 million or less. On February 28, 2007, the ruling of the court was published to the effect that the value of the benefit was assessed at $ 10,000,000 and costs were ruled to counsel for the plaintiff in the sum of 6% of the sum of the benefit, or a total sum of NIS 2,514,000 plus VAT, and remuneration to the plaintiffs in the sum of NIS 400,000 (including VAT). DBS and the cable companies decided that the division between the parties would be 70% and 30%, and accordingly, on April 26, 2007, DBS's share (30% of the total sum) was transferred to counsel for the class plaintiff. On April 16, 2007, the class plaintiffs filed an appeal to the Supreme Court against the sum set as remuneration to the plaintiffs, and an application to increase such sum. On May 16, 2007, DBS together with the cable companies filed a counter appeal regarding the valuation of the benefit (and accordingly, regarding the fees of counsel for the plaintiffs), and regarding the plaintiff's remuneration. On September 3, 2007, a preliminary hearing took place on the appeals in the Supreme Court. The Court made various proposals for concluding the matter in a settlement, but these were not accepted by the class plaintiffs. On September 18, 2007, a ruling was handed down instructing the filing of the parties' closing statements in writing. The appellants are to file their written closing statements in the appeal by March 27, 2008, and the closing statements in response in the appeal and closing statements in the counter-appeal are to be filed by June 26, 2008. The Company will file closing statements in writing in the appeal and in the counter appeal by May 29, 2008, and closing statement sin response in the counter appeal by July 10, 2008. The date of the hearing of the appeals has been set down for August 7, 2008. On November 20, 2007, DBS and the plaintiffs filed notice of consent regarding the broadcast of alternative content in lieu of the content referred to in section 13.1.2 of the settlement agreement between them of November 9, 2006, but prohibiting broadcast of it on the sports channel, Channel 5. According to the notice, the parties have agreed that in lieu of each cycle in which such game will not be broadcast, two games will be broadcast live on Channel 5 in a different cycle, without this being at the expense of other games which the channel is required to broadcast as part of its regulatory obligations, including games of senior teams in the Spanish league. This notice was submitted for the sake of caution only, since prima facie, the honorable Court already

acceded to this on November 18, 2007, apparently as part of approval of an identical arrangement between the Plaintiffs and the cable companies in Civil File 2474/02 Tomer Rotem & 6 Ors v. Matav Cable Communications Systems Ltd. & Ors. On December 27, 2007, DBS filed an application to approve the notice regarding the substitute content. On February 20, 2008, the court approved the notice regarding the substitute content.

5.18.7 Proceedings regarding deficit demand from the Customs Department: In December 2006, a deficit demand was sent to Eurocom Digital Communications Ltd. (in this section: "Eurocom Communications") from the Customs Department, for payment of purchase tax and VAT (including linkage differentials, interest and fines) in the sum total of approximately NIS 10 million, for decoders purchased by DBS from Eurocom Communications, and imported by it for DBS, smart cards belonging to DBS having arrived with such decoders. Eurocom Communications and DBS have mounted objection proceedings against the deficit demand, the dispute dealing with the proper classification of the smart cards for the purposes of purchase tax. DBS has provided the sureties required by the Customs Department for assurance of the taxes in dispute and DBS and Eurocom Communications have agreed that DBS will bear any payments required under the deficit demand, if any. In the opinion of DBS's and Eurocom Communications' legal advisers, there is a reasonable chance of no effective debt in respect of the sum of approximately NIS 5 million out of the deficit demand, which is in respect of VAT, and there is a reasonable chance of subtraction or cancellation of the linkage differentials, interest and fines included in the deficit demand. In November 2007, a written objection to the deficit demand was filed. As at the date of this report, a decision has not yet been made with respect to the objection to the deficit demand.

5.18.8 Arbitration with HLL Communications - in February 2008, a settlement was signed between DBS and HLL Communications Ltd. (hereinafter: HLL) which is an interested party in DBS to terminate the arbitration proceedings that had been taking place between the parties with respect to the sum of the monthly payment owing to HLL for the lease of space segments on the Amos 2 satellite under the agreement between the parties (see section 5.16.2 above).

5.18.9 On July 11, 2007, an application was filed with the District Court at Tel Aviv to approve the filing of a class action against DBS and against Pizza Meter Co. Ltd., which was later substituted under the amended application of the applicant with Pizza Meter Holdings Ltd. (hereinafter: "Pizza Meter") with respect to a campaign by DBS under which subscribers who joined the campaign were entitled to 52 vouchers for a family pizza from Pizza Meter for one year (hereinafter: the "approval application"). According to the applicant, in May 2007, there was a change in the policy for exercising these vouchers, mainly in that delivery services were no longer provided, and this made it impossible to exercise the vouchers, in contravention of the conditions promised to subscribers when they joined the campaign. The applicant seeks to sue DBS on grounds of breach of contractual obligation, breach of duty of good faith in entering into a contract, unjust enrichment, misleading conduct and unfair trading due to false description. The remedies sought in the application with respect to the class action are the following alternative remedies: (a) restitution of the cost of all of the pizzas and/or the value of all vouchers from the date on which the conditions of the vouchers changes until the end of the period set out in the vouchers, to every customer who joined the campaign. The rate of restitution sought shall be calculated at the price of one family pizza according to Pizza Meter's price list, i.e. NIS 48 (in the applicant's personal claim, he seeks restitution of NIS 1,824 under this head of damage). (b) Payment of the cost of delivery for all vouchers, from the date on which the conditions of the vouchers changed until the end of the period set out in the vouchers, to every customer who joined the campaign, calculating in accordance with the cost a tripartite delivery (delivery to the customer's home to take the voucher, delivery to the Pizza Meter branch to get the pizza and delivery back to the customer's home, within a period of no more than one hour after the time of ordering), i.e., NIS 60 per delivery (in his personal claim, the applicant seeks restitution of the sum of NIS 2,280 under this head of damage). On September 2, 2007, Pizza Meter gave notice to DBS of termination of exercise of the campaign vouchers by it as of September 6, 2007, following transfer of title to and all of the rights in the Pizza Meter brand from Pizza Meter Holdings Ltd. to Pizza Meter Israel – Management (2005) Ltd. Following termination of the campaign by Pizza Meter, on September 20, 2007, the applicant filed an application to amend the application for approval (the "amendment application") in order to approve the addition of these new facts, and noted that this was a litigant's admission on the part of the respondents regarding the

blatant breach of their undertakings. In October 2007, DBS wrote to all of its subscribers via a yes-mail notice, offering them, ex gratia, another benefit in lieu of the campaign vouchers. In this letter, DBS offered its subscribers two alternative benefits for them to choose from: (1) vouchers to purchase pizzas from Domino's Pizza; or (2) an offer to receive a yesMax decoder for two years, for no payment. On December 24, 2007, the applicant filed an "amended application for approval" after the court had acceded to the second amendment application. On March 2, 2008, DBS's response to the application for approval was filed. In this response, the applicant's allegations were dismissed outright, and it was noted, inter alia, that DBS's letter to all of its customers regarding substitute benefits made the application for approval baseless, both theoretically and factually.

5.18.10 For additional legal proceedings see Note 17 to the Company's financial statements for the year ended December 31, 2007, which are included in this periodic report.

5.19 Goals and Business Strategy

5.19.1 DBS's goals are to continue the trend of increasing DBS's revenues, by continuing a gradual increase in the number of DBS subscribers, and by continuing the increase in average revenue per subscriber (ARPU).

5.19.2 In order to achieve these goals, DBS intends to invest considerable efforts in the field of marketing and sales and in appropriate marketing strategies, which are intended for the continued recruitment of subscribers, via DBS's sales system, to continue its efforts to create differentiation and innovation in the content of its broadcasts and increasing such compared with those of the cable company and by increasing the content purchased by each subscriber; to continue expanding DBS's added value services, and to continue investing in customer services and in retention of existing customers and to increase revenues from them. These efforts include DBS's striving to increase penetration of PVR decoders among its subscribers so as to increase DBS's revenues and its subscribers' loyalty to DBS's services, the option of marketing a total service package alongside television services and internet browsing packages together with telephony services, either by obtaining a license to provide VOB services or by marketing the telephony services of a third party, and launching VOD services.

5.19.3 DBS's goals with respect to increasing the number of subscribers and the ARPU are based on forecasts by management of DBS, based on the current trend in the broadcast market and on DBS's presumptions regarding competition in the field of broadcasts and regulations, which apply and which shall apply to DBS's operations and the restrictions imposed upon DBS and its operations, taking into account the restrictions applying to and that shall apply to the Company, which affect DBS. However, the forecasts of management of DBS might not come to fruition due to changes in demand in the broadcast market, due to increased competition in this field and due to regulatory restrictions imposed or which might be imposed on DBS or on its joint ventures with the Company (see section 5.6.5 above). Realization of DBS's goals with respect to the launch of VOD and telephony services depend, in addition to the above, on obtaining the statutory and regulatory consents required for such purpose (see section 5.6.5 above), and for VOD services, on the Company's agreement to provide such under conditions that will enable the service to be provided, from DBS's point of view, on the availability of Bezeq's DSL network and on the ability to provide the service at a quality level for DBS's subscribers (see section 5.6.5F above). Increasing the penetration rates of PVRs depends also on the availability of such decoders and the dates of supply of them by the manufacturer.

5.20 Extraordinary Event in DBS's Business

On September 5, 2007, non-continuous disruptions began to occur in DBS's broadcasts, which occurred on a variety of waves, power and scope which caused disruptions, at various strengths, to the quality and availability of DBS's broadcasts, mainly in the north of the country and along the coast. The disruptions to broadcasting also gave rise to extraordinary loads on DBS's customer service center, which caused difficulties in receiving service. In order to locate the source of the disruptions, DBS set up teams to locate and pinpoint the disruptions, with the cooperation of specialists in this area, and with the assistance of various governmental bodies as well. To the best of DBS's knowledge, and as informed to it by government bodies following the location operations, the source of the disruptions was external, was not within DBS's control and was not related to it. The disruptions ceased on October 9, 2007 and have not occurred since, as at the date of

publication of this report. To the best of DBS's knowledge, the disruptions were caused due to broadcasting operations in the frequency range in which DBS's broadcasts are transmitted from the satellites that it uses to the dishes in subscribers' homes. Therefore, despite the fact that the disruptions have stopped as at the date of this report, there is no certainty that a disrupting transmission of this kind may not occur again in the future.

The frequency range in which DBS operates as aforesaid was permitted for its use under a license granted to DBS by the Ministry of Communications prior to its commencing commercial operations (see section 5.8.1.4 above), in respect of which DBS paid and continues to pay appropriate fees. In this regard, in October 2007, the Government resolved as follows:

A. Further to the operations done by the Ministry of Communications, the Ministry of Defense and the Foreign Ministry to cease the disruptions to reception of the broadcasts of YES, to appoint an inter-ministerial committee headed by the Director General of the Ministry of Communications, and with the participation of a representative of the Foreign Ministry, a representative of the Ministry of Defense, a representative of the Ministry of Finance and a representative of the Ministry of Justice, to examine all of the aspects and issues arising with respect to these disruptions, and in broader contexts as well.

B. To instruct the relevant government ministries to give the matter appropriate priority. The team to be appointed as set out in section A above shall place special emphasis on the issues arising in the field of mass communications in cases of emergency.

C. The team shall provide the Government with an interim report by mid November 2007."

Despite the fact that the disruptions to its broadcasts had been caused by external entities and not by DBS's own act or omission, DBS had opened all of the channels marketed by it (with the exception of erotic channels and pay per view movie channels) to all of its subscribers for free, for a period of three months from the middle of October 2007 until January 15, 2008, and subscribers who, under their contracts, pay a separate fee to purchase "premium" channels will be credited for such payment. This compensation and the other expenses and damages caused to DBS with respect to these disruptions caused harm to DBS's financial results.

5.21 Discussion of Risk Factors

The following are the threats, weaknesses and risk factors of DBS (hereinafter: the "**Risks**") deriving from its general environment, from the industry and from the special nature of its operations. It should be emphasized that the risks set out below are rated according to various levels of reasonableness of occurrence, and the reasonableness of the occurrence of some of them, in DBS's assessment, would be very low. However, each risk has an affect irrespective of the reasonableness of its coming about.

5.21.1 <u>Macro risks</u>

5.21.1.1 Financial risks – a substantial part of DBS' expenses and investments are linked to fluctuations in the exchange rate of the US dollar. Therefore, strong fluctuations in the exchange rate will have a substantial effect on the business results of DBS. In addition, loans taken out by DBS from banks, from its shareholders and from institutional entities are partly linked to the consumer price index and therefore sharp rises in inflation might have a substantial affect on DBS's business results; the loans taken out by DBS from banks are, as at the date of this report, at variable interest rates and therefore, sharp rises in interest rates might have a substantial affect on the business results of DBS.

5.21.1.2 Recession – an economic recession, increase in unemployment rates and a decrease in disposable income might bring about a decrease in the number of DBS' subscribers, a decrease in DBS' revenues and harm to its business results.

5.21.1.3 Security situation – a continued unstable security situation in most of Israel, which disrupts the day-to-day lives of residents, might bring about a downturn in DBS's business results.

5.21.2 <u>Sector Risks</u>

5.21.2.1 Dependence on licenses – DBS provides multi-channel television broadcasts in accordance with a broadcast license and via other licenses. Breach of the provisions of the licenses are likely to bring about, subject to the conditions set out for such in the licenses, the cancellation amendment or suspension of the

licenses and as a result of such, substantial harm to DBS's ability to continue operating in the field, and to imposition of monetary sanctions on DBS.

5.21.2.2 Changes in regulation – DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies, and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of consents from the Council and the Ministry of Communications. A very high level of regulatory intervention and changes in regulation have an effect on DBS' operations and could substantially harm its financial results.

5.21.2.3 Strong competition – the field of broadcasts is characterized by a very high penetration rate and very strong competition, which requires DBS to constantly and continually be investing in recruiting and retaining customers; and dealing with high transfer rates of customers between DBS and the cable company. The offer of a bundle of services containing multi-channel television, internet and telephony, which are not offered in this format by DBS, also increases the ability of the cable company to compete. Non-provision of VOD services by DBS when the cable company does offer such services to its customers also harms DBS's ability to compete.

5.21.2.4 Development of new technology – there is a risk in the development of new technology which will prevail over existing technology and turn the existing technology into old technology, and as a result a need for large monetary investments in order to retain competitive standing or alternatively in the event of development of new technologies that enable entry into the field of multi-channel broadcasts without making heavy financial investments, the entry barriers into the field might be lowered and this will constitute a threat to DBS's competitive status. For IPTV technology see section 5.1.4.2 above.

5.21.2.5 Setting up alternative infrastructure to that of multi-channel broadcasts – amendments to legislation and regulations might enable the setting up of infrastructure or systems for provision of television services that might constitute a substitute for DBS's services. For the terrestrial distribution system see section 5.1.3.3 above. For digital radio broadcasts see section 5.1.1 above.

5.21.2.6 Types of payments and supervision of tariffs – DBS's license provides the kinds of payments that DBS is permitted to collect. In addition, the Council has the power not to approve amendments to the price list or campaigns or discounts initiated by DBS. These restrictions affect DBS's ability to conduct its own commercial prices policy.

5.21.2.7 Piracy – DBS is exposed to attempted pirated connection by viewers wishing to receive DBS broadcasts without paying a subscription fee. DBS assesses this phenomenon as being marginal only.

5.21.2.8 Exposure to claims regarding broadcast of content that breaches legal provisions – DBS is exposed to claims regarding broadcast of content that breaches legal provisions, including breach of intellectual property rights, damage to privacy, damage to good name, broadcast of prohibited content, etc. Its agreements with content suppliers and program producers usually include an undertaking by the supplier / producer to indemnify DBS in the event of contact that infringes the provisions of the agreement and the law.

5.21.3 <u>Special risks to DBS</u>

5.21.3.1 Need for receiving consents from financing banks for the performance of operations by DBS – the doing of operations and certain proceedings are dependent upon the receipt of the prior consent of the banks. This restriction might hinder DBS's operations.

5.21.3.2 Exposure to the provision of immediately repayable credit as a result of non-compliance with loan agreements – failure by DBS to comply with the provisions of the financing agreement or with the provisions of the deed of trust signed with the trustee for the debenture holders might, in accordance with and subject to the provisions of each of the aforesaid agreements respectively, give the relevant

lenders grounds for making all of the credit provided to DBS immediately repayable and the exercise of the securities provided by DBS and its shareholders to the banks. Exercise of such securities by the banks constitutes grounds for making the debentures immediately repayable, however, making the debentures immediately repayable constitutes grounds for making the bank credit immediately repayable.

5.21.3.3 Restrictions that are the result of the ownership structure – restrictions imposed upon the Company restrict it from providing sources of finance to DBS and from cooperating for the purpose of offering a communications service bundle. These restrictions substantially affect DBS's commercial situation and its ability to compete – see section 5.6.4.2A above.

5.21.3.4 Maintenance of sufficient cash flow – DBS is required to maintain cash flows sufficient for compliance with its business plan and with payment of the credit that it took. Failure to pay such credit on time constitutes grounds for making the bank credit and debentures immediately repayable in accordance with and subject to the provisions and restrictions of the financing agreement and the deed of trust, accordingly.

5.21.3.5 Failure and damage to satellite – DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space. The duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a failure in one of the satellites, it will be possible to move most of the channels broadcast by DBS via the existing space segments on the other satellite, and perhaps even via additional segments on the satellite that might be made available for DBS's use. DBS has no insurance for loss of revenues causes due to satellite malfunction. The Amos 1 satellite is expected to end its life during the second half of 2008 (see section 5.16.2 above). In addition, during the first half of 2008, HLL might launch another satellite (Amos 3) which shall be situated in the same position in space. A failure of launch or of properly placing Amos 3 will significantly increase the risk involved in harm to the Amos 2 satellite.

The aforesaid is forward looking information, which is based, to the best of DBS's knowledge, on calculations by the IAI. However, technical malfunctions and other events may change the lifespan of the Amos 1 satellite (see section 5.16.2 above).

5.21.3.6 Dependence on the holders of rights in space segments – DBS is dependent upon HLL and the IAI as holders of the rights in space segments (the IAI with respect to Amos 1, which is owned and operated by it, and HLL with respect to Amos 2, which is owned by it). Since these two satellites are in an identical part of space, if DBS is unable to lease the space segments of one of the rights holders and it is only possible to lease the space segments of the other supplier, DBS estimates that its business results will not be substantially affected. However, after the end of the lifespan of the Amos 1 satellite, DBS will be very substantially dependent upon HLL as the exclusive holder of rights and the sole supplier of space segments used by DBS.

The above is forward-looking information, based on the assessments of management of DBS regarding the availability of space segments on the remaining satellite, and on exercise of DBS's right to back-up with the supplier. However, failure by the supplier to meet such back-up obligations might cause substantial harm to DBS's business results.

5.21.3.7 Dependence on software, equipment, content, infrastructure and service suppliers – DBS depends upon the Company, which enables DBS to purchase internet packages which constitute a very important component of the package sold to DBS's subscribers. If the Company does not supply DBS with the services, DBS's ability to compete will suffer; in addition DBS is dependent upon certain software, equipment, content and service providers and failure to receive the products or services provided by them might harm DBS's ability to function or its rate of growth.

5.21.3.8 Dependence on use of internal wiring – DBS depends on the use of internal wiring in subscriber homes, which is owned by the cable company, and the use of which is effected in accordance with the administrative order. As set out in section 5.15.3 above, in 2005, the Ministry of Communications gave notice that it was considering canceling the administrative order. If the administrative order is cancelled, without an appropriate alternative arrangement enabling one supplier to make use of the infrastructure of the other in subscriber homes, this will constitute a substantial barrier to the recruitment of subscribers to DBS.

5.21.3.9 Harm to broadcast centers – harm to a broadcast center might cause a significant difficulty for continued broadcasts, however, the splitting of broadcasts into two broadcast centers (Kfar Saba and Reem Junction) significantly reduces the risk involved in harm to one of them and improves the possibility that most of the broadcasts will survive. As at the date of these reports, DBS broadcasts from both of the broadcast centers at once, some channels being broadcast from one center and DBS's home channels being broadcast only from Kfar Saba, and being stored at the broadcast center at Kfar Saba only. Should one of the broadcasting centers be damaged, DBS will transfer most of its broadcasts through the other broadcasting center, however, as at the date of these reports, in the event of harm to its broadcasting center at Kfar Saba, DBS will have a limited ability to transmit DBS's home channels via the other broadcasting center. DBS is working to improve the survivability of its home channel broadcasts form the secondary broadcast center (including with respect to the option of storing and encrypting such content).

DBS's assessment as set out in this paragraph is forward-looking information. This assessment is based on the provision of back-up services from the supplier with whom DBS has contracted, in the event of harm to the broadcast center at Kfar Saba. This assessment might not be realized or might be partially realized or otherwise, if DBS is not permitted to receive such back-up services.

5.21.3.10 Technical inferiority and the inability to offer combined services – DBS's technology is technically inferior to that of its competitors. This technical inferiority prevents DBS from providing telephony services, internet and various interactive services, including VOD, over its infrastructure, and requires it to purchase these services or to enter into joint venture agreements in order to provide such services to its customers.

5.21.3.11 Inability to offer a combined analog and digital package – DBS provides its customers with digital decoders only, whilst the cable company can provide both analog and digital decoders. The offer of two kinds of decoders makes the cost of equipment cheaper for subscribers, and improves the cable company's ability to compete.

5.21.3.12 Defects in the encryption system – DBS's broadcasts are based on the encryption of broadcasts transmitted via satellites and encoded via smart cards that are installed in the decoders in subscribers' homes. Defects in the encryption system or breach of it might enable broadcasts to be viewed without payment being made to DBS, thereby causing a reduction in revenues and a breach of the agreements between DBS and its content suppliers.

5.21.3.13 Exposure due to broadcast of channels without an agreement – DBS broadcasts approximately 10 channels to its subscribers which are broadcast from their broadcast origin as unencrypted satellite broadcasts, and which can be received in Israel (even without a decoder) without any agreement with the owners of the broadcast rights. DBS makes an effort to regulate contracts with owners of broadcasting rights.

5.21.3.14 Exposure to payments of stamp duty - DBS might be required to pay stamp duty on agreements which it signed before stamp duty was repealed. DBS has made an appropriate provision in its financial statements.

5.21.3.15 Exposure to class actions – given the large number of its subscribers, DBS is exposed to class actions and the more subscribers, the greater the exposure to class actions in significant sums. For applications pending against DBS for approval of claims as class actions see section 5.18 above.

5.21.3.16 Compliance with conditions and instructions of the Ministry of the Environment regarding the broadcast center – in the event of failure to comply with the conditions and instructions of the Ministry of the Environment with respect to the broadcast center, DBS is exposed to the sanctions set out in the law.

5.21.3.17 Secondary allocation of frequency range – the frequency range used by DBS to transmit its broadcasts from the broadcast satellites to the satellite dishes installed at subscribers' homes, and allocated in accordance with a license by the Ministry of Communications is defined as the frequency range allocated under secondary allocation, such that there is an Israeli entity which is permitted to make primary authorized use of the frequency range. If the owner of the primary allocation uses the frequency range on an ongoing and significant basis, disruptions may occur to the quality and/or availability of DBS's broadcasts to its subscribers which might cause harm to the financial results of DBS. As at the date of this report, to the best of DBS's knowledge, the owner of the primary allocation has not made use of these frequencies in such a way as to cause significant and/or ongoing disruptions to DBS's broadcasts. Since DBS's broadcasts are wireless transmissions from the broadcast satellites on which DBS leases space segments, to the satellite dishes in subscribers' homes, the broadcast of wireless signals in the same frequency range might cause disruptions to the quality and/or availability of the broadcasts provided by DBS to its subscribers and harm to its financial results.

5.21.3.18 Disturbances to broadcasts – since DBS's broadcasts are wireless transmissions from broadcast centers to broadcast satellites and from those to the reception dishes in subscriber homes, the broadcast of wireless signals in the same frequency range, and extreme weather conditions of heavy rain, hail or snow, might cause disruptions to the quality and/or availability of the broadcasts provided by DBS to its subscribers and may cause harm to its financial results. (For the disturbance that took place in September – October 2007 and the government decision in that matter, see section 5.20).

5.21.4 The following table sets out the risk factors based on their nature and ranking according their effect in the opinion of DBS's board of management. Note that DBS's assessments below regarding the level of exposure of DBS to a risk factor reflects the level of impact of such risk factor presuming realization of the risk factor, and this shall not amount to an assessment nor shall it give any weighting to the chances of the realization of such factor. Likewise, the order of appearance of the risk factors above and below is not necessarily based on the risk involved in each risk factor, or the probability of its occurrence:

	Level of Effect		
	Large	**Medium**	**Small**
Macro risk			
Financial risks		**X**	
Security situation			**X**
Recession			**X**
Industry Risk			
Dependence on licenses		**X**	
Changes in regulation	**X**		
Strong competition	**X**		
Development of new technology	**X**		
Tariff control			**X**
Piracy			**X**
Exposure to claims for broadcasting infringing content			**X**
Special Risk			
Need for approval for company operations from financing banks			**X**
Exposure to bank credit becoming immediately repayable due to non compliance with financing agreements		**X**	

	Level of Effect		
	Large	**Medium**	**Small**
Restrictions due to structure of ownership	**X**		
Need for sufficient cash flows	**X**		
Satellite malfunction		**X**	
Dependence upon space segment supplier		**X**	
Dependence on suppliers of content, equipment and infrastructure	**X**		
Dependence on suppliers of essential content		**X**	
Damage to broadcast centers	**X**		
Technical inferiority and inability to offer combined services		**X**	
Inability to offer combined analog and digital packages			**X**
Encryption system	**X**		
Exposure regarding broadcast of channels without agreement			**X**
Stamp duty			**X**
Legal Proceedings		**X**	
Compliance with environmental restrictions			**X**
Secondary allocation of frequencies			**X**
Disruptions of broadcasts		**X**	

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Shlomo Rodav – Chairman of the Board

Avi Gabbay, CEO

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

Chapter B of the Periodic Report
Directors' Report on the State of the Company's Affairs
For the year ended December 31, 2007

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies together are hereinafter referred to as "the Group"), for the year ended December 31, 2007 (hereinafter: "the Directors' Report").

The Group operates in four main areas which are reported as business segments in the Company's consolidated reports as set forth below:

1) **Fixed-line domestic communications**

2) **Cellular**

3) **International communications, internet services and NEP**

4) **Multi-channel television**

The Company has other areas of activity which are not material to the Group's operations, and these have been included in the Company's financial statements on December 31, 2007 as a business segment consisting mainly of customer call center services and investment in a venture capital fund.

In January 2007, BezeqCall merged with Bezeq International and they constitute in this statement one business segment: international communications, internet services and NEP.

The profit in the reporting year amounted to NIS 1,361 million compared to NIS 750 million in 2006. The increase in profit is mainly due to an increase in operating profit of NIS 1,565 million in 2006 to NIS 2,336 million in 2007. The increase in operating profit is mainly due to an increase in revenues in all the segments, with the exception of the domestic fixed-line communications segment, a decrease in salary expenses mainly from expenses in 2006 for allocation of options to employees of NIS 287 million, and a decrease in early retirement expenses of NIS 218 million compared to 2006. See below for further details.

1. Financial position

A. The financial statements are drafted in accordance with International Financial Reporting Standards (IFRS)

B. The Group's assets on December 31, 2007 amounted to NIS 15.16 billion, compared to NIS 17.55 billion on December 31, 2006. Of these, NIS 6.06 billion (40%) are property, plant and equipment, compared to NIS 6.49 billion (37%) on December 31, 2006.

Most of the decrease stems from the fixed-line domestic communications segment. There was a decline in total assets in this segment, not including investment in subsidiary companies, compared to the previous year, in the amount of NIS 2.90 billion, mainly due to the decline in the cash balances and the realization of financial assets held for trading which were used mainly for distribution of a dividend. In addition, there was a decrease in the depreciated cost of property, plant and equipment resulting from the difference between depreciation expenses and the investment made in the reporting year. The decrease in total assets was offset by an increase in the customer balance mainly due to a delay in issuing bills for customers.

In the cellular segment, assets increased from NIS 3.97 billion on December 31, 2006 to NIS 4.34 billion on December 31, 2007. Most of the increase was due to an increase in the cash balance. In addition, there was an increase in the customer balance due to an increase in sales in payment installments and the termination of credit card payments. On the other hand, there was a reduction in the tax asset due to realization of the asset recorded in the past for losses, and a decrease in the depreciated cost of property plant and equipment.

In the international communications, internet and NEP services segment, there was an increase in total assets compared to December 31, 2006, mainly due to an increase in the customer balance and advance expenses for users rights that were offset by a reduction in the cash balances used for early repayment of loans and tax advance payments.

In the multi-channel television segment, there was an increase in total assets compared to December 31, 2006, which was mainly due to an increase in broadcasting rights and an increase in the net investment balance in property, plant and equipment.

C. The shareholders' equity of the Company on December 31, 2007 amounted to NIS 4.54 billion, comprising 30% of the total balance sheet, compared to NIS 5.76 billion on December 31, 2006, which comprised 33% of the total balance sheet. The decrease in shareholder' equity is due to dividends paid in the amount of NIS 2.56 billion. The decrease was moderated by the Group's net earnings.

D. Total Group debt on December 31, 2007 amounted to NIS 7.15 billion, compared to NIS 8.02 billion on December 31, 2006. The Group's debt to financial institutions and debenture holders on December 31, 2007 amounted to NIS 6.78 billion, compared to NIS 7.46 billion on December 31, 2006. The decrease is mainly due to payment of Eurobonds in the domestic fixed line communications segment in the amount of NIS 1.7 billion and payment of loans and debentures in the cellular segment. In addition, there was a decrease in loans in the multi-channel television segment and early payment of loans in the international communications, internet services and NEP segment.

The decrease was partially offset mainly by the sale of debentures to institutions in the domestic fixed-line communications segment in the amount of NIS 1.2 billion and issue of debentures in the multi-channel television segment in the amount of NIS 614 million.

The Company's auditors have highlighted the financial position of DBS, as specified in Note 33(3) to the financial statements. As at the balance sheet date, DBS is not in compliance with the financial conditions set for it in the financing agreement. Subsequent to the balance sheet date DBS is in compliance with the financial conditions set for it in the financing agreement as at December 31, 2007, following a relief extended by the banks at that date. DBS applied to banks to update the conditions for 2008 in a way that would be compatible with the company budget. As at the approval date of the financial statements, the banks have approved DBS' s application for an update of the conditions for 2008. The continuation of the company's operations is also conditional on compliance with the conditions set for 2008 and/or with further reliefs it may received during the year. The management of DBS believes that the financial resources available to it will be sufficient for its operating needs in the coming year based on the forecasted cash flow approved the by Company's board of directors.

E. The Group's cash and other current investment balances on December 31, 2007 amounted to NIS 1.59 billion compared to NIS 3.59 billion on December 31, 2006. The decrease is mainly due to a decrease in the cash balance and realization of commercially held securities in the domestic fixed-line communications segment, which were used to pay a dividend in the amount of NIS 2.86 billion, and for payment of liabilities.

In the international communications, internet services and NEP segment, there was a decrease in the cash flow that was used for early payment of loans and advanced tax payments.
The decrease was partially offset by an increase in cash balances in the cellular segment, sale of debentures in the fixed-line domestic communications segment, debt raising in the multi-channel television segment and the cash flow from current operations in the principal segments of the Group's operations.

2. Results of operations

A. Principal results

Net earnings attributable to the shareholders of the Company for 2007 amounted to NIS 1,330 million, compared to net earnings of NIS 809 million in 2006. The rise in the net earnings is mainly due to an increase in operating income which increased by NIS 771 million (49%) in 2006.

Below are details of the changes in the results of the segments compared to 2006.

Segment	2007 Profit (NIS millions)	2006 Profit (NIS millions)
Fixed-line domestic communications	1,279	746
Cellular	804	692
International communications, internet services and NEP	203	119
Multi-channel television	50	8
Total	2,336	1,565

For details of the consolidated results see main data from the Group's Statement of Income in Section J below.

Basic earnings per share in 2007 amounted to NIS 0.51 per NIS 1.00 par value (diluted earnings per share amounted to NIS 0.50 per NIS 1.00 par value) compared to basic and diluted earnings per share of NIS 0.31 per NIS 1.00 par value in 2006.

B. **Revenue**

Group revenue in 2007 amounted to NIS 12.40 billion compared to NIS 12.23 billion in the previous year.

Revenues from fixed-line domestic communications decreased from NIS 5.80 billion in 2006 to NIS 5.71 billion in the reporting year (a decrease of 2%). Most of the decrease in the segment's revenues is attributable to a decrease in interconnect fees to the cellular networks due to tariff reductions. The decrease was accompanied by a parallel decrease in the segment's operating expenses. In addition, revenues decreased in the segment due to a decrease in tariffs in July 2006 and June 2007 and a reduction in call traffic. The decrease in revenues was moderated mainly by ongoing growth in revenues from high-speed internet service (ADSL) and by an increase in income from data communication services. The Company's auditors continue to highlight the growing competition and the impact of regulation.

Revenues from the cellular telephone segment increased from NIS 4.48 billion in 2006 to NIS 4.68 billion in the reporting year. The increase is due to an increase in revenue from sale of terminal equipment, mainly due to an increase in the quantity of handsets sold and upgraded. In addition, there was an increase in revenue from cellular services, following an increase in content revenue and an increase in the number of subscribers, which was mainly set off by price erosion.

Revenue in the international communications, internet and NEP services segment amounted to NIS 1.30 billion in the reporting period, and remained the same as in 2006. In this segment there was an increase in revenues from internet broadband service and from an increase in revenue from outgoing calls. In contrast, there was a decrease in operations relating to transfer of calls between communication operators around the world.

Revenues in the multi-channel television segment increased from NIS 1.36 million in 2006 to NIS 1.41 million in the reporting year, resulting from an increase in the number of subscribers and an increase in the average revenue per customer.

C. **Depreciation and amortization**

The Group's depreciation and amortization expenses decreased from NIS 1.86 billion in 2006, to NIS 1.77 billion in the reporting year, mainly due to a decrease in the depreciation expenses in the domestic fixed-line communication segment due to full depreciation of property plant and equipment and a decrease in investments in new.

D. **Salaries**

The Group's salary expenses in 2006 decreased from NIS 2.59 billion in 2006 to NIS 2.38 billion in the reporting year. The decrease in salary is mainly due to expenses resulting from allocation of options to employees in the amount of NIS 287 million, charged in 2006 to the domestic fixed-line communication segment. The decrease in expenses due to early retirement of employees in the domestic fixed-line communications sector was offset by salary increases in this segment and in the other segments in the Group.

E. **General and operating expenses**

The Group's operating and general expenses in 2007 amounted to NIS 5.84 billion, compared to NIS 5.97 billion in 2006.

In the fixed-line domestic communications segment, operating and general expenses decreased from NIS 2.23 billion in 2006 to NIS 2.12 billion in the reporting year. The decrease is mainly due to a reduction in interconnect expenses to cellular operators, services and maintenance by subcontractors and building maintenance, which were offset by an increase in royalty expenses and general expenses, mainly due to an increase in interconnect expenses to fixed-line domestic communication operators.

In the cellular segment, general and operating expenses increased from NIS 2.73 billion in 2006 to NIS 2.79 billion in the reporting year, mainly due to an increase in costs of terminal equipment due to an increase in the quantity of handsets sold and an increase in access fees to telecom operators and content expenses as well as an increase in revenues from cellular services. In addition, there was an increase in advertising expenses mainly due to preparation for number portability.

In the international communications, internet services and NEP segment there was a decrease in general and operating expenses from NIS 836 million in 2006 to NIS 774 million in the reporting year. The decrease is mainly due to a reduction in operations relating to call transfers between communication operators around the world alongside revenues.

In the multi-channel television segment, general and operating expenses increased from NIS 889 million in 2006 to NIS 909 million in the reporting year, resulting from an increase in general expenses and advertising expenses, mainly due to costs resulting from the disruption of broadcasting services in September and compensation for customers. The increase was offset by a decline in content expenses in the use of satellite segments and a decrease in royalty expenses.

F. **Other operating expenses (income), net**

The Group's other net operating expenses originated mainly from the domestic fixed-line communications segment. These expenses decreased from NIS 250 million in 2006 to NIS 79 million in the reporting year, mainly due to a decrease in expenses recorded for provision for severance pay in early retirement and a decrease in capital gain.

G. **Operating income**

The Group's operating income in 2007 amounted to NIS 2.34 billion, compared to NIS 1.57 billion in the previous year, an increase of NIS 771 million. The increase in operating income is due to the changes in the results of the segments described above in the revenue and expenses sections. These changes brought about an increase in operating income in all of the segments.

H. **Financing expenses - net**

The Group's net financing expenses in 2007 amounted to NIS 309 million compared to NIS 338 million in 2006, a reduction of approximately NIS 29 million.

The Group's debt to financial institutes and debenture holders is mainly linked to the CPI and the financing expenses are affected by fluctuations in the index. In the reporting year there was a rise in the index compared to 2006 and revaluation of liabilities led to an increase in the Group's financing expenses.

In the domestic fixed line communications segment, there was an increase in net financing expenses compared to 2006. This is mainly due to a decrease in revenues in the capital market and realization of deposits and securities and a decrease in their return. In this segment there is an increase in expenses due to revaluation of CPI-linked liabilities and the foreign currency exchange rate, which was partially offset by hedging transactions. In addition, in 2006, there was a decrease in financing expenses for canceling the provision for termination of the disputes with the Ministry of Communications.

In the cellular segment, there was a decrease in financing expenses, mainly due to the reduction in liabilities and the decrease in the dollar exchange rate. The decrease was partially offset by the increase in expenses for revaluating CPI-linked liabilities as a result of a rise in the index.

In the multi-channel television segment net financing expenses in 2007 amounted to NIS 168 million compared to NIS 319 million in 2006. The increase in the CPI led to an increase in financing expenses due to the revaluation of CPI-linked liabilities. On the other hand, the fair value of the shareholders' loans was recalculated due to postponement of the expected payment dates. This change increased the financing income in the multi-channel television segment by NIS 213 million, and in the Group by NIS 96 million. This increase in the income of the Group was attributed to the minority interest in the subsidiary company, and accordingly, did not affect the profit attributed to the shareholders of the Company.

I. **Income tax**

The Group's tax expenses in 2007 amounted to NIS 672 million, representing approximately 33% of pre-tax profit, compared to NIS 488 million in 2006, representing 39% of pre-tax profit. Most of the decrease in the rate of tax on profits before income tax is due to a 2% reduction in the tax rate and a decrease in losses in the multi-channel television segment for which deferred tax assets are not recorded.

J. **Main data from the Group's consolidated statements of income** (in NIS millions)

	Q1 2007	Q2 2007	Q3 2007	Q4 2007	2007	2006
Revenues	3,089	3,053	3,139	3,120	12,400	12,232
Costs and expenses (1)	2,432	2,482	2,543	2,607	10,064	10,667
Operating income	657	570	596	513	2,336	1,565
Financing expenses – net (2)	58	73	134	44	309	338
Earnings before Group's equity in earnings of associates	599	497	462	469	2,027	1,227
Equity in earnings of associates	1	1	1	3	6	11
Earnings before income tax	600	498	463	472	2,033	1,238
Income tax (3)	215	158	132	167	672	488
Earnings for the year	385	340	330	305	1,361	750
Attributable to:						
The Company's shareholders	399	361	255	315	1,330	809
Minority rights	(14)	(21)	75	(10)	31	(59)
Earnings for the year	385	340	330	305	1,361	750

Comparison of 2007 fourth quarter results with the results of the third quarter

Details of the material changes:

(1) The total costs and expenses increased by NIS 64 million compared with the prior quarter. The increase is mainly due to an increase in operating expenses in the cellular segment, as a result of costs incurred by the preparation for number portability. In the domestic fixed-line communications segment, there was an increase in the fourth quarter as a result of updating the liabilities for early retirement and other actuary liabilities, which were offset by an increase in capital gain.

(2) Net financing expenses decreased by NIS 90 million compared to the prior quarter. The financing expenses in the prior quarter were mainly affected by an increase in the CPI to which most of the Group's liabilities are linked, by a decrease in return on investments and by income recorded in the prior quarter in connection with the change in terms for the shareholders' loans in the multi-channel television segment amounting to NIS 96 million.

(3) The increase in the effective tax rate in the fourth quarter is due to the increase in the losses of DBS for which the Company does not record deferred tax assets.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2007 amounted to NIS 3.07 billion, compared to NIS 3.79 billion in 2006, a decrease of NIS 719 million. The decrease in cash flows generated by operating activities is mainly due to revenues and expenses not involving cash flows resulting from changes in the assets and liabilities items, including an increase in the customer balance and payments for early retirement. The decrease was offset by the increase in earnings.

Cash flows generated by operating activities are one of the sources of financing of the Group's investments, which during the reporting year included NIS 973 million invested in development of communications infrastructures, compared to investments amounting to NIS 953 million in 2006. During the reporting year, the Group realized investments in net financial assets of NIS 705 million, compared to net investments of NIS 1.54 billion in 2006.

In the reporting year, the Group repaid debts and paid interest of NIS 3,193 million, of which NIS 1,927 million was on account of debentures, NIS 840 million in loans, NIS 37 million in short-term credit, and NIS 389 million in interest payments. The Group raised new debt amounting to NIS 1,864 million by taking loans in the amount of NIS 50 million and issuing debentures in the amount of NIS 1,814 million, compared to payment of net debt and interest payments in the amount of NIS 2,058 million in 2006. The Company has a cash flow from net considerations for removal of derivative financial instruments, serving to hedge loans, in the amount of NIS 77 million in 2007 compared to a net payment of NIS 76 million in 2006.

In the reporting year, cash dividends in the amount of NIS 2.86 billion were paid, compared to NIS 1.6 billion in 2006.

The monthly average short-term credit balance from banks in 2007 amounted to NIS 88 million. The monthly average of long-term liabilities to financial institutions and debenture holders in 2007 amounted to NIS 7,305 million

The working capital on December 31, 2007 was negative, and amounted to NIS 676 million, compared to negative operating capital on December 31, 2006 that amounted to NIS 1,214 million, a decrease of NIS 538 million in deficit. The increase in the working capital is due to an increase in working capital in all the segments in which the Group operates with the exception of the domestic fixed line communications segment.

In this segment there was an increase in the working capital deficit compared to the previous year in the amount of NIS 573 million. The increase is mainly due to a decrease in cash flow and cash value and realization of commercially held financial assets. On the other hand, there was a decrease in current liabilities mainly due to a decrease in current maturities of loans and debentures, obligation to pay a dividend that was recorded last year and a decrease in current provisions related to benefits for employees and others. The working capital was used mainly to pay the dividend and pay off liabilities.

4. Considerations of the board of directors in deciding on or recommending payments to each of the five highest salary recipients among its officers

The salary of the five highest-salaried officers was approved by the authorized entities of the Company, as relevant. The board of directors agrees that the salary levels of the officers do not deviate from the convention in similar corporations in the country.

5. Group involvement in the community and donations

The Group is active in the community through its involvement in social institutions and organizations such as the education system in underprivileged areas and the confrontation line. Its contributions in the reporting year amounted to NIS 1.8 million. In addition, Group employees volunteer in additional and diverse community involvement activities.

During the reporting year the Company donated NIS 1.3 million. The principal recipients are listed below:

In the project "Children and Parents Study Computer and Internet", which has been ongoing for some six years, the Company's employees voluntarily mentor underprivileged parents and children on selected subjects in computers and the internet.

In the “Summer for the Community” project, which the Company has run for four years now, employees’ children worked in medical institutions and community centers during the summer. The cost of the project to the Company was NIS 940,000.

The Company’s employees and pensioners established the Milk, Bread and Eggs association. The association works in cooperation with the local authorities to locate disadvantaged families in order to supply them with basic food products.

Pelephone has no binding policy regarding donations and its management discusses each case on an individual basis. During the reporting year, Pelephone donated NIS 30,000 to various associations.

Bezeq International is involved in ongoing operations on behalf of underprivileged communities in Petach Tikva, it adopted “lone” soldiers and a combat division and participated in projects for children with special needs. During the reporting year, Bezeq International's expenses amounted to NIS 500,000.

6. Exposure to and management of market risks

Responsibility for management of the Company’s market risks

The Deputy CEO and CFO is responsible for management of the Company's market risks. In the reporting year, Ran Oz filled this position and from February 15, 2008 Alan Gelman fills this position. For details of their education and experience, see Section 13 (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, inflation, the prices of raw materials and equipment, and the prices of securities.

Interest – The Company’s debentures bear fixed interest and therefore change in the interest rate will affect the fair value and not their book value.

The Company has investments in negotiable bonds that are shown in the Company's books at their market value. This market value is influenced by changes in the interest rates in the economy.

At the date of this report, the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that it will do so under future market circumstances. Furthermore, the Company takes into account such influences when considering the types of loans it takes and when managing its investment portfolio.

Exchange rates – A change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future earnings and cash flows, mainly the repayment of currency-linked liabilities and payments for the currency-linked purchase of equipment and raw materials.

In order to minimize this exposure, the board of directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed an amount equivalent to $150 million, of which not more than the equivalent of $50 million would relate to currencies other than the US dollar. In addition, the Company is able to implement additional hedging transactions from time to time against exposure to expected transactions during one year of operation, this being limited to a total volume not exceeding the equivalent of $100 million – of which not more than the equivalent of $30 million would relate to currencies other than the U.S. dollar The reduction of exposure during the reporting year was accomplished by means of forward transactions (or sale according to exposure direction) in currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward transactions is equal to or shorter than the time frame of the hedged exposure.

The Company recorded no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing revenues of approximately NIS 106 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year.

The Company's tariff updating mechanism as set forth in the Regulations allows tariffs to be updated according to the rise in the CPI (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its distribution over the year can have a material influence on the erosion of the Company's tariffs and on its revenues. On the other hand, the influence of the rate of inflation on the Company's expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms.

In addition, the Company invests a considerable part of its cash balances in unlinked shekel value deposits, and these investments are exposed to changes in their real yield caused by a change in the rate of inflation.

The Company has a surplus of liabilities over CPI-linked assets. As part of its policy of minimizing exposure, the Company has made hedging transactions against the CPI so as to reduce this risk.

The Company recorded no significant costs in making hedging transactions against the index, since they were made as forward transactions. The financial statements include financing revenues of NIS 56 million from these hedging transactions.

Prices of raw materials and equipment – Cash flows generated by the Company's operations are used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral price indices, exchange rates and global prices. The Company does not hedge against this exposure.

Prices of securities – The Company invests some of its financial balances in securities. The investment policy was determined by the Company's board of directors. With the aim of preventing fluctuations in the portfolio's yield, the board of directors set investment principles whereby most of the investment will be in bonds and shekel deposits. The types of investment and their proportional part in the investment portfolio were determined according to criteria based on linkage, rating, redemption date, liquidity and risk. In addition, a separation between government and non-government bonds was defined. A monetary ceiling was also determined for the various types of investments.

Risks and risk management in the consolidated companies - The persons responsible for management of the market risks in the principal consolidated companies are the CFOs of those companies and at Pelephone, the company treasurer as well. The consolidated companies make hedging transactions in accordance with the decisions of their boards of directors and under their supervision.

The consolidated financial statements include financing income of NIS 141 million from hedging transactions in the reporting year.

Linkage based report - Note 30 to the Financial Statements includes information on the linkage terms of the financial assets.

There were substantial changes during the year in the domestic fixed-line communications segment. These changes led to a change in the linkage conditions of the monetary balances: a reduction in the euro-linked liabilities due to payment of debentures (Eurobonds) in the amount of NIS 1.7 billion and sale of index-linked debentures to institutions in the amount of NIS 1.2 billion.

Below a sensitivity analysis of the Group's assets and liabilities to changes in foreign currency exchange rates, the CPI, interest and market prices of securities

Sensitivity analysis 2007 (in NIS millions)

Sensitivity to changes in the dollar/NIS exchange rate - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%	At a dollar rate of 3.846	-5%	-10%
Cash	8	4	83	(4)	(8)
Trade receivables	6	3	58	(3)	(6)
Other receivables	0.1	0.1	1	(0.1)	(0.1)
Other investments, including derivatives	4	2	35	(2)	(4)
Long-term trade receivables	2	1	25	(1)	(2)
Accounts payable	(31)	(16)	(313)	16	31
Other liabilities	(0.1)	(0.1)	(1)	0.1	0.1
Firm commitments – space sections	(34)	(17)	(343)	17	34
Firm commitments - suppliers	(43)	(22)	(435)	22	43
Firm commitments - rent	(4)	(2)	(45)	2	4
Firm commitments – vehicle leasing	(2)	(1)	(19)	1	2
Guarantees	8	4	85	(4)	(8)
Hedging instruments not recognized for accounting					
Dollar/shekel forward transactions	35	18	(11)	(18)	(35)
Total	**(51)**	**(26)**	**(880)**	**26**	**51**

The table shows the items sensitive to fluctuations in the dollar/shekel exchange rate. The sensitivity of the items in the balance sheet was tested, as were off-balance sheet items. The firm commitments are off-balance sheet commitments, denominated and/or linked to the dollar and therefore sensitive to changes in the exchange rate.

Sensitivity to changes in the euro/NIS exchange rate - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%	At a euro rate of 5.6592	-5%	-10%
Cash	0.3	0.2	3	(0.2)	(0.3)
Other investments, including derivatives	6	3	56	(3)	(6)
Loans and debentures	(3)	(2)	(31)	2	3
Accounts payable	(1)	(0.4)	(8)	0.4	1
Current liabilities	(0.1)	-	(1)	-	0.1
Hedging instruments not recognized for accounting					
Total	**2.2**	**0.8**	**19**	**(0.8)**	**(2.2)**

The table shows the items sensitive to changes in the euro/shekel exchange rate.

Sensitivity to changes in the sterling/NIS exchange rate - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%	At a sterling rate of 7.7105	-5%	-10%
Investments in securities	0.1	-	1	-	(0.1)
Total	**0.1**	**-**	**1**	**-**	**(0.1)**

The Company has securities exposed to the pound sterling. The fair value of the securities was calculated by multiplying the market price on December 31, 2007 with the nominal value held by the Company at that time.

Sensitivity to changes in the CPI – 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%		-5%	-10%
Trade receivables	-	-	15	-	-
Investments and debit balances	-	-	11	-	-
Long-term receivables	-	-	24	-	-
Other liabilities and provisions	(0.3)	(0.1)	(131)	0.1	(0.3)
Firm commitments – vehicle leasing	(0.1)	(0.1)	(52)	0.1	(0.1)
Firm commitments - rent	(1)	(1)	(579)	1	(1)
Firm commitments - suppliers	(0.2)	(0.1)	(105)	0.1	(0.2)
Guarantees	-	-	(33)	-	-
Debentures issued to financial institutes and others	(2)	(1)	(776)	1	(2)
Debentures issued to financial institutes and others	(2)	(1)	(928)	1	(2)
Debentures issued to financial institutes and others	(1)	(1)	(650)	1	(1)
Bank loans	(1)	(0.5)	(461)	0.5	(1)
Loans from others	(0.3)	(0.1)	(137)	0.1	(0.3)
Loans provided by the minority in a subsidiary	(1)	(0.4)	(375)	0.4	(1)
Hedging instruments not recognized for accounting					
Hedging transactions against the index	7	4	53	(4)	(7)
Total	**(1.9)**	**(1.3)**	**(4,124)**	**1.3**	**(15.9)**

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 Group has debentures and loans from banks and other sources, which are linked to the index.

Sensitivity to changes in real shekel interest rates - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%		-5%	-10%
Debentures issued to the public - Series 4	7	4	(1,340)	(4)	(7)
Debentures issued to the public - Series 5	36	18	(1,706)	(19)	(37)
Debentures issued to financial institutes and others	5	2	(776)	(2)	(5)
Debentures issued to financial institutes and others	12	6	(928)	(6)	(12)
Debentures issued to financial institutes and others	24	12	(650)	(13)	(26)
Bank loans	4	2	(461)	(2)	(4)
Loans from others	8	4	(137)	(4)	(8)
Total	**96**	**48**	**(5,998)**	**(50)**	**(99)**

The Group's companies have index-linked debentures at fixed interest. The debentures are sensitive to changes in the real shekel interest rate.
The fair value of non-negotiable debentures was calculated by discounting the future cash flows. The Company also has index-linked loans affected by the change in the real shekel interest rate. Their fair value is calculated by discounting the future cash flows.

Sensitivity to changes in nominal NIS interest rates - 2007

	Profit (loss) from changes			Fair value	Profit (loss) from changes		
	12%	**10%**	**5%**		**-5%**	**-10%**	**-12%**
Investments and debit balances		(1)	(0.4)	150	0.4	1	
Long-term trade receivables		(2)	(1)	176	1	2	
Long-term trade receivables		(6)	(3)	936	3	7	
Hedging instruments not recognized for accounting							
Dollar/shekel forward transactions	1	0.5	0.2	(11)	(0.2)	(0.5)	(1)
Total	**1**	**(8.5)**	**(4.2)**	**1,251**	**4.2**	**9.5**	**(1)**

The sensitivity analysis of the shekel interest rate in dollar/shekel forward transactions includes another scenario (12% up and 12% down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 12% in December 2001).

Sensitivity to changes in shekel dollar interest rates - 2007

	Profit (loss) from changes			Fair value	Profit (loss) from changes		
	15%	**10%**	**5%**		**-5%**	**-10%**	**-15%**
Firm commitments – space sections	7	5	2	(343)	(2)	(5)	(7)
Hedging instruments not recognized for accounting							
Dollar/shekel forward transactions	(1)	(0.4)	(0.2)	(11)	0.2	0.4	1
Total	**6**	**4.6**	**1.8**	**(354)**	**(1.8)**	**(4.6)**	**(6)**

The sensitivity analysis of the dollar interest rate includes another scenario (15% up and 15% down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 15% in June 2003).
The increase in the dollar interest lowers the fair value of forward transactions by reducing the interest difference.

Sensitivity to changes in prices of negotiable shekel securities - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	2.50%	**1.25%**		**-1.25%**	**-2.50%**
Investment in securities	2	1	78	(1)	(2)
Total	**2**	**1**	**78**	**(1)**	**(2)**

The Company has unlinked shekel debentures. The sensitivity analysis of the shekel debentures (unlinked) was made at values of 1.25% and 2.5%, based on a historical examination of the maximum change in prices of shekel debentures.

Sensitivity to changes in prices of index-linked negotiable securities - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	2%	**1%**		**-1%**	**-2%**
Investment in securities	3	1	149	(1)	(3)
Total	**3**	**1**	**149**	**(1)**	**(3)**

The sensitivity analysis of the debentures was made at values of 1% and 2%, based on a historical examination of the maximum change in the prices of index-linked and foreign currency-linked debentures.

Sensitivity to changes in prices of dollar-linked debentures - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	2%	1%		-1%	-2%
Investment in securities	0.1	-	4	-	(0.1)
Total	**0.1**	**-**	**4**	**-**	**(0.1)**

The Company has both government and non-government (company) debentures linked to the dollar.

Sensitivity to changes in prices of negotiable securities - 2007

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%		-5%	-10%
Shares	3	2	34	(2)	(3)
Convertible debentures (shares)	0.1	0.1	1	(0.1)	(0.1)
Other	0.2	0.1	2	(0.1)	(0.2)
Total	3.3	2.2	37	(2.2)	(3.3)

	Profit (loss) from changes			Fair value	Profit (loss) from changes		
	118%	10%	5%		-5%	-10%	-80%
Shares	5	0.4	0.2	4	(0.2)	(0.4)	(3)
Total	5	0.4	0.2	4	(0.2)	(0.4)	(3)

The sensitivity analysis of the share includes another scenario (118% up and 80% down), which examines the most extreme daily change that occurred in the last five years (a maximum daily change of 118% on March 6, 2003 and a minimum daily change of 80% on August 13, 2002.

Sensitivity analysis 2006 (in NIS millions)

Sensitivity to changes in the dollar/shekel exchange rate - 2006

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%	At a dollar rate of 4.225	-5%	-10%
Cash	5	2	48	(2)	(5)
Trade receivables	6	3	60	(3)	(6)
Other investments	13	7	131	(7)	(13)
Suppliers and service providers	(38)	(19)	(381)	19	38
Firm commitments	(56)	(28)	(556)	28	56
Firm commitments – space sections	(42)	(21)	(417)	21	42
Guarantees	(9)	(5)	(93)	5	9
Hedging instruments not recognized for accounting					
Dollar/shekel forward transactions	23	12	(7)	(12)	(23)
Total	**(98)**	**(49)**	**(1,215)**	**49**	**98**

The table shows the items sensitive to changes in the dollar/shekel exchange rate. The sensitivity of the items in the balance sheet was tested, as were off-balance sheet items. The firm commitments are

off balance-sheet commitments, denominated and/or linked to the dollar and therefore sensitive to changes in the exchange rate.

Sensitivity to fluctuations in the euro/NIS exchange rate – 2006

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%	At a euro rate of 5.5643	-5%	-10%
Cash	0.5	0.2	5	(0.2)	(0.5)
Trade receivables	0.7	0.4	7	(0.4)	(0.7)
Other investments	3	1	27	(1)	(3)
Deposit investments	4	2	39	(2)	(4)
Eurobonds	(169)	(85)	(1,691)	85	169
Debentures	(3)	(2)	(33)	2	3
Accounts payable	(2)	(1)	(20)	1	2
Hedging instruments not recognized for accounting					
Euro/shekel forward transactions	157	79	(31)	(79)	(157)
Total	**(8.8)**	**(5.4)**	**(1,697)**	**5.4**	**8.8**

The table shows the items sensitive to changes in the euro/shekel exchange rate. The forward transactions for purchase of euro against shekels are for up to seven months. These transactions serve as hedges against the euro denominated-linked debt.

Sensitivity to changes in the CPI - 2006

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%		-5%	-10%
Trade receivables	-	-	12	-	-
Other receivables	-	-	15	-	-
Other debits	0.1	-	61	-	(0.1)
Other liabilities and provisions	(0.4)	(0.2)	(199)	0.2	0.4
Firm commitments - leasing	(0.4)	(0.2)	(214)	0.2	0.4
Firm commitments - orders	(0.4)	(0.2)	(220)	0.2	0.4
Firm commitments - rent	(1)	(0.6)	(548)	0.6	1
Guarantees	-	-	(33)	-	-
Non-negotiable debentures	(4)	(2)	(1,829)	2	4
Bank loans	(3)	(1)	(1,316)	1	3
Loans from others	(0.3)	(0.1)	(135)	0.1	0.3
Loans provided by the minority	(1)	(0.6)	(564)	0.6	1
Hedging instruments not recognized for accounting					
Index/shekel forward transactions	3	1	(14)	(1)	(3)
Total	**(7.4)**	**(3.9)**	**(4,984)**	**3.9**	**7.4**

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 Group has debentures and loans from banks and other sources, which are linked to the CPI.

Sensitivity to changes in real shekel interest rates 2006

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	10%	5%		-5%	-10%
Non-negotiable debentures	19	10	(1,829)	(10)	(19)
Debentures issued to the public - Series 4	14	7	(1,279)	(7)	(14)
Debentures issued to the public - Series 5	12	6	(483)	(6)	(12)
Bank loans	4	2	(1,316)	(2)	(4)
Loans from others	7	4	(135)	(5)	(9)
Total	**56**	**29**	**(5,042)**	**(30)**	**(58)**

The companies of the Group have non-negotiable debt and index-linked bank loans to institutional entities. The table tests the sensitivity of the debt to changes in the real interest rate.

Sensitivity to changes in shekel interest rates - 2006

	12%	10%	5%	Fair value	-5%	-10%	-12%
Dollar/shekel forward transactions	0.6	0.5	0.3	(7)	(0.3)	(0.5)	(0.6)
Euro/shekel forward transactions	4	3	2	(31)	(2)	(3)	(4)
Investments in deposit		(0.9)	(0.5)	183	0.5	0.9	
Long-term trade receivables	(7)	(6)	(3)	794	3	6	7
Total	(2.4)	(3.4)	(1.2)	939	1.2	3.4	2.4

The sensitivity analysis of the shekel interest rate includes another scenario (12% up and 12% down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 12% in December 2001).

Sensitivity to changes in dollar interest rates - 2006

	15%	10%	5%	Fair value	-5%	-10%	-15%
Dollar/shekel forward transactions	(0.8)	(0.5)	(0.2)	(7)	0.3	0.5	0.8

The sensitivity analysis of the dollar interest rate includes another scenario (15% up and 15% down), which examines the most extreme daily change that occurred in the last ten years (a daily change of 15% in June 2003).

The fair value of the forward transactions was calculated by discounting the difference between the price set on the date of measurement for forward transactions for the same future date, and the price in the transaction signed by the Company, multiplied by the nominal value of the transaction and discounted from the date of clearing the transaction to the measurement date.

The interests rates used to calculate the fair value are the risk-free rates for the relevant year (shekel interest and dollar interest).

Sensitivity to changes in euro interest rates - 2006

	10%	5%	Fair value	-5%	-10%
Euro/shekel forward transactions	(3)	(2)	(31)	1	3

Sensitivity to changes in securities rates 2006

	Profit (loss) from changes			Fair value	Profit (loss) from changes		
	12%	10%	5%		-5%	-10%	-12%
Shares	4	4	2	36	(2)	(4)	(4)

	Profit (loss) from changes			Fair value	Profit (loss) from changes		
	118%	10%	5%		-5%	-10%	-80%
Share	9	0.8	0.4	8	(0.4)	(0.8)	(6)

The sensitivity analysis of the share portfolio includes another scenario (12% up and 12% down), which examines the most extreme situation (a daily change at that level would result in suspension of trading in the security).

Sensitivity to changes in securities rates 2006

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	2%	**1%**		**-1%**	**-2%**
Index-linked debentures	10	5	479	(5)	(10)
Foreign currency	2	0.9	90	(0.9)	(2)
Total	12	5.9	**569**	(5.9)	12

The sensitivity analysis of the debentures was made at values of 1% and 2%, based on a historical examination of the maximum change in prices of index-linked and foreign currency-linked debentures.

Sensitivity to changes in securities rates 2006

	Profit (loss) from changes		Fair value	Profit (loss) from changes	
	2.50%	**1.25%**		**-1.25%**	**-2.50%**
Unlinked shekel debentures	7	4	289	(4)	(7)

The sensitivity analysis of the shekel debentures (unlinked) was made at values of 1.25% and 2.5%, based on a historical examination of the maximum change in prices of shekel debentures.

7. Directors with accounting and financial expertise

A. The Company's Board of Directors determined that the minimum number of directors who have accounting and financial expertise, as required by the provisions of the Companies Law, is one (and together with the external directors – two). The Board of Directors believes that this number will enable it to fulfill the duties imposed upon it by law and by the 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 (chairman), Zehavit Cohen, Menachem Inbar, Yoav Rubenstein, David Gilboa, Eyal Yaniv (external director) and Yitzhak Edelman (external director). For information about their relevant education and experience, see Section 12 in Chapter D of the Periodic Report.

8. Disclosure regarding an internal auditor in a reporting corporation

8.1 The Company's internal auditor

a. Name: Malka Dror

b. Date of commencement of office: August 14, 2006 (appointed as substitute), and from June 28, 2007, permanent appointment

c. The internal auditor complies with the conditions set forth in Article 3(A) of the Internal Audit Law. Qualifications: BA in Economics (Hebrew University); CISA (Certified Information Systems Auditor) – USA)

Internal auditing experience: 23 years in various internal auditing positions

d. The internal auditor complies with the provisions of Article 8 of the Internal Audit Law and Article 146(B) of the Companies Law.

e. Mrs. Dror (who has been employed in the Company since 1985) was allocated, before her appointment to the position of internal auditor, options to purchase Company shares as part of two allocations of options to all the employees in the Company: 44,287 options to purchase the Company's shares held by the State as part of an option outline for Company employees for 2005 on November 15, 2005, within the framework of the State's obligations in connection with the Company's privatization process (at the report date the auditor exercised and sold 14,763 of these options), and 32,856 options of the Company to purchase its shares as part of the option outline for Company employees on February 22, 2007 in accordance with the Company's obligation under the collective agreement from 5 December 2006. In addition, pursuant to a resolution adopted by the board of directors on March 10, 2008, the internal auditor will be allocated 100,000 options as part of allocation of options to middle-managers in the Company according to an outline to be published in the next few days. The Company believes that these holdings do not affect the quality of the internal auditor's work.

f. The Internal Auditor has no material business connections or other material connections with the Corporation or with a body affiliated to it.

g. Employment basis: The internal auditor is a Company employee.

8.2 Method of appointment

Audit committee discussions at its meetings on June 17, 2007 and June 21, 2007.

The committee recommended appointing Malka Dror as the Company's internal auditor. Later on, the committee recommended appointing her to the Company management and granting her salary conditions and accompanying rights that are within the range of those granted to VPs in the Company. The board of directors approved the appointment on June 28, 2007.

Summary of the reasons for approving the appointment

The board of directors approved the appointment of Malka Dror, who served as acting internal auditor, as internal auditor following the recommendation of the audit committee, due to her qualifications and professional experience.

Duties, authority and tasks of the internal auditor

The authority and responsibility of the Company's internal auditor are determined in the regulation "Internal Auditor of the Company". The regulation was revised and approved by the board's audit committee on December 27, 2007.

Duties of the internal auditor according to the Company's internal audit regulation

a. To examine the propriety of the Company's operations, officers and senior employees from the following aspects: compliance with applicable laws and regulations and proper business practices; principles of sound management, thrift, efficiency, and integrity, to verify that they were carried out lawfully by a qualified person, that they were accepted according to business considerations and that they contribute to the achievement of the Company's defined goals; compatibility with the policy and decisions made by the board of directors and Company management.

b. To examine the reliability and quality of the financial and operational information

c. To inspect the cash management, the Company's liabilities and arrangements to safeguard the Company's assets and their entirety, and their operative efficiency and use

d. To investigate whether the Company's decisions, including those made by the board of directors and its committees, were made in accordance with proper procedures.

e. To audit the Company's computerized information systems and information security system

f. As required, to audit material transactions in the Company, including the procedures for their approval. In this matter, "material transactions" include the purchase or sale of

material operations, transactions as set forth in Article 270 of the Companies Law, and irregular transactions as defined in the Companies Law.

g. To examine the propriety and effectiveness of the Company's procedures for entering into commitments.

h. To recommend the definition or amendment of procedures on material issues, which the internal auditor believes to require determination or amendment.

i. To expose shortcomings in the Company's business practices, identify the reasons for their existence, and note the causes responsible for them, and to make proposals for correcting the shortcomings and preventing their recurrence

j. To re-audit in order to monitor the correction of the shortcomings and implementation of the decisions made following the audit report.

Authorities of the Company's internal auditor according to the Company's internal audit regulation

a. The Company's internal auditor may demand and receive any information, explanation and document required at her discretion for the performance of her duty, and every Company employee is obliged to furnish any document or information at the Company's internal auditor's first request. Every Company employee requested to provide information to the auditor is required to comply with the request at the time and in the manner determined thereat.

b. The manager and employees of the audited department will allow the internal auditor and audit staff to perform the audit and will assist them with any request.

c. For performance of her duty, the internal auditor shall be granted access to any ordinary or computer databank, to any database and to any automated or non-automated data processing work program in the Company.

d. The internal auditor may enter and inspect any of the Company's assets.

e. The above authorities are also granted to audit department staff and to any person acting on behalf of the internal auditor.

f. Participation in meetings of the management, board of directors and its committees:

1. The internal auditor will be invited to all audit committee meetings.
2. The internal auditor will be invited to all meetings of the board of directors and its committees and will have the right to participate in them, at her discretion.
3. The internal auditor will receive the material attached to the invitation to the meetings of the board of directors and its committees.
4. The internal auditor will be invited to all management committee meetings.
5. Notwithstanding the aforesaid in subclause (2) and (3), the chairman of the board will have the right to decide, at his discretion, that the internal auditor will not be invited to some of the board and committee meetings (that are not audit committee meetings) that have particularly sensitive agendas, and/or the internal auditor will not receive the background material for the discussions of these issues. The board chairman will inform the internal auditor and audit committee chairman of his decision before the meeting.
6. The internal auditor will receive, routinely, the minutes of all the meetings of the board of directors and its committees (including minutes of the discussions on subjects in which the internal auditor did not participate as specified in subclause (5) above.

g. The internal auditor may ask the chairman of the audit committee to convene the committee to discuss a subject defined in his request; the chairman of the audit committee will convene the committee within a reasonable time from the date of the request, should he deem fit.

h. The internal auditor may, with the approval of the audit committee chairman, examine a complaint received by the auditing department as part of the auditing work.

i. At least once a year, the Company's internal auditor will hold a work meeting with each of the internal auditors of the Company's subsidiaries to discuss the subsidiary company's audit plan and its implementation.

j. The Company's internal auditor will be authorized to ask for copies of the subsidiary companies' audit reports, as required according to her consideration.

8.3 Organizational officer responsible for the internal auditor

According to a resolution of the Company's board of directors, the chairman of the board is the organizational officer responsible for the internal auditor.

8.4 Work program

a. The work program is annual.

b. **Considerations in determining the internal audit work program**

The guiding principle behind the annual work program for 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 program.

The considerations taken into account in the compilation of the work program are as follows: reasonable coverage of all the Company's areas of business according to exposure to material risk (finance; sales and marketing; personnel and payroll, investments, mergers and acquisitions; safety and security; information technology – IT; economics and logistics; engineering and planning).

c. **Entities involved in determining the work plan**

Preparation of follow-up checks – at the request of the board's audit committee or the recommendation of the internal auditor. In addition to the subjects determined in the annual work program, the audit prepares 'special examinations. These examinations are not included in the work program, and are prepared at the request of the board chairman, audit committee chairman or the CEO.

d. **The entity accepting and approving the work plan**

The board's audit committee

e. **The auditor's consideration to deviate from the work plan**

The auditor may propose subjects at her discretion or at the request of the CEO. In any event the approval of the audit committee chairman is required

f. During the reporting year the auditor did not examine any material transactions

8.5 The audit's response to corporations comprising a material holding

The work plan of the auditing department does not include audit in corporations representing material holdings In all the corporations representing material holdings of the Company, there are 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 senior executives of the Company serve. The internal auditor may, under the amended regulation, receive the audit reports of the subsidiaries' statements and hold meetings with each of the auditors of the subsidiary companies, at least once a year, to discuss the audit plan and its implementation in the subsidiary company.

Scope of employment

a. **Number of hours of employment in the year**

The audit's work program for 2007 included 10,800 audit hours. (In 2006 – 12,000 audit hours).
The internal audit unit at the end of the reporting year employed six fulltime auditors, including the internal auditor.

b. **Reduction in volume of internal auditor's work in the reporting year**

Due to the Company's reorganization and the retirement plan, the number of employees in the internal audit department was reduced in 2007 – from twelve auditors (including the internal auditor) to six auditors at the end of the reporting year (another auditor left after the reporting year – in January 2008).

8.6 Preparation for audit

a. **Work standards**

The Company's internal audit is prepared according to the binding standards of the Institute of Internal Auditors (I.I.A.).

b. **The board's criteria for ensuring that the auditor complies with all the provisions in the standards**

In 2004 an external audit investigation of Bezeq's internal audit department was carried out in compliance with Standard 1312 of the IIA, which requires one external audit every five years. The conclusion of this audit was that the work of the Company's internal audit department complies with accepted professional internal audit standards

8.7 Accessibility to information

The internal auditor has been furnished with documents and information as stipulated in Article 9 of the Internal Audit Law, and she has been granted permanent direct access to the Company's information systems, including financial data.

8.8 Auditor's report

a. The internal auditor submits the audit reports in writing.

b. The internal auditor routinely submits the audit reports during the reporting year to the board chairman, CEO, audit committee chairman and committee members.

During the reporting year, 20 audit reports regarding the Company were prepared as well as a control risk survey and a total of 16 audit reports were submitted. Of these reports, 14 were prepared and submitted in the reporting year. Two reports prepared in 2006 were submitted in the reporting year. Another 6 reports prepared in the reporting year were submitted after the reporting year. The submission dates are as follows: January – one report (prepared in 2006), March – 3 reports (1 prepared in 2006), April – one report, July – 2 reports, August – one report, September – 2 reports, October – one report, November – 3 reports, December – control risk survey, January 2008 – 4 reports prepared in 2007, February 2008 – 2 reports prepared in 2007.

c. **Dates on which the audit committee convenes**

The board's audit committee regularly discusses the audit reports submitted by the internal auditor during the reporting year. Over the course of the year, the committee held 24 meetings. The following table presents the meeting dates during the reporting year, divided into quarters:

Q1	Q2	Q3	Q4
February 20, 2007	April 17, 2007	July 8, 2007	October 21, 2007
March 14, 2007	May 15, 2007	July 15, 2007	November 7, 2007
	May 22, 2007	July 16, 2007	November 13, 2007
	June 5, 2007	August 30, 2007	November 20, 2007
	June 17, 2007	September 25, 2007	November 25, 2007
	June 21, 2007		December 13, 2007
	June 28, 2007		December 19, 2007
			December 24, 2007
			December 27, 2007
			January 15, 2008 This meeting was held instead of the meeting which had been scheduled for December 2007 and was postponed.

At these meetings, 21 audit reports were discussed. Ten of the reports discussed were published during the reporting year and eleven at the end of the previous reporting year.

In addition to discussions of the audit reports, the committee discussed additional subjects that it is obligated by law to discuss and decide.

8.9 Assessment of the board of directors regarding the work of the Internal Auditor

Based on sections 8.1 – 8.8 above and the reports received from the internal auditor, we, the Company's board of directors, believe that that the scope of the Company audit performed in 2007, the nature and continuity of the internal auditor's activities, and the work program, are reasonable in the circumstances and they achieve the objectives of the audit

8.10 Remuneration

a. The internal auditor is not one of the five highest salaried of the corporation's senior officers. The employment conditions of the internal auditor were discussed and approved by the audit committee and board of directors on August 30, 2007 and on October 21, 2007 and were approved later by the board of directors on October 25, 2007, as follows: Monthly salary of NIS 40,000 linked to the CPI at the date of appointment as the Company's acting internal auditor in August 2006. Annual target-based bonus determined by the audit committee and approved by the board of directors, up to 35% of the annual salary without related expenses.

b. As set forth in section (8.1)(e) above, the internal auditor holds options that were allocated to her as a Company employee before her appointment as internal auditor. The audit committee, in its meeting on January 20, 2008, recommended allocation of 100,000 options to the internal auditor as part of the options plan for middle managers. The allocation was approved by the board of directors on March 10, 2008 and as on the report date has not yet been implemented.

c. The board of directors believes that the remuneration received by the internal auditor does not affect her professional judgment.

8.11 Disclosure of exposure caused by non-compliance with conditions

The binding conditions in the matter of the Company's internal auditor have been fulfilled pursuant to the fourth appendix of Article 10(b)(11) or pursuant to any law.

9. Critical accounting estimates

The preparation of the financial statements according to international accounting principles obligates the management to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities. Management bases its estimates and assessments on past experience and on additional factors, value appraisals and opinions which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments based on various assumptions and conditions. Information on the principal matters of uncertainty in critical assessments and judgments in the application of the accounting policy is provided in the Financial Statements (see Note 2F). We believe that these assessments and estimates are critical because every change in them and in the assumptions has the potential to materially affect the financial statements.

Estimated useful life of property, plant and equipment

The estimated useful lives of fixed assets serve to determine the depreciation expenses that will be recorded in the reporting year.

The main part of the telecommunications infrastructure is managed in accordance with asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past experience, taking into consideration expected technological changes, Company plans or other changes. If such changes take place earlier than expected or differently from expected, the remaining useful life of such assets may be shortened. This results in an increase in future depreciation expenses. If the changes take place later than expected, the remaining useful life may be extended, and this results in a decrease in the depreciation expenses. Given the importance of the Group's depreciation expenses in respect of the above changes, the effect on the operating results and the financial condition of the Group can be extremely significant.

Assessing the value of property, plant and equipment

Certain items of property, plant and equipment have been re-estimated to fair value upon the transition to IFRS based on their deemed cost, which was determined on the basis of their value on the transition date (January 1, 2005) in accordance with the Group's estimate based on the valuation of an

external appraiser (attached as an appendix to the financial statements). In addition, the costs of dismantling, clearing and restoring sites were capitalized to the date of transition to IFRS.

The residual value of the Company's copper cables was assessed by the Company, based on the opinion of an external appraiser (attached as an appendix to the financial statements).

The use of estimates and value appraisals affects the fixed asset and depreciation expenses items – see Note 9 to the Financial Statements.

Liability for employee benefits

These liabilities are based on actuarial calculations which include many calculation assumptions which can be different in practice. The assumptions relate, *inter alia*, to interest rates for capitalization, mortality tables, wage creep and leaving rates. For details, see the actuary's letter attached to the financial statements.

With regard to changes in estimates in respect of these liabilities benefits, see Note 16 to the Financial Statements.

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since the Company's business plans anticipate realization of the tax benefit. By nature, actual business results may differ from business plans, and this can affect the future realization of the tax benefit (see Note 8 to the financial statements).

Provisions and contingent liabilities

The Group's companies have contingent liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions of extremely significant amounts are pending against Group companies.

The Company makes regular estimates of the potential liabilities associated with every claim and complaint. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is reasonable for the Company to bear the costs of settling claims and whether they can be reliably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with charges for the Company, in amounts materially different from the provisions included in the financial statements, if any. For details of contingent liabilities, see Notes 15 and 17 to the financial statements.

Provision for uncertain debts

The financial statements include a provision for doubtful debts calculated in general terms from the volume of trade receivable balances, based on assessments and past experience, and specifically in respect of debts whose collection is in doubt. Actual results might differ from the assessments and estimates made, and could affect the results of operations accordingly (see Note 7 to the financial statements).

Goodwill and the value of investment in subsidiary companies

The value of the Company's holding in DBS and in Pelephone, for examining the need for a reduction in respect of impairment, is calculated by estimating the present value of future cash flows. The estimate is based on various forecasts, including, among others, projected cash flows for the coming years, a forecast of the number of subscribers and average revenue per user (ARPU), and the business forecasts. These are based on assumptions, estimates and sensitivity to changes in the discount interest rate (see Note 10 to the financial statements).

Options plan for employees

The fair value of the options granted to Company employees was determined according to the Company's assessment, based on the opinion of an external appraiser (attached as an appendix to the financial statements). The value set reflects the fair value of the services rendered to the Company in exchange for the options, and was measured by the Black and Scholes model and based on parameters that include the share price, the exercise price, volatility and average useful life. The value is also sensitive to a risk-free interest rate of government bonds (see Note 26 to the financial statements).

Assessment of financial instruments

The value of financial instruments is calculated according to the classification, based on market prices, present value of the cash flows and various value assessment models. The values are sensitive to changes in the parameters serving as the basis for these assessments (see Note 30 to the financial statements).

10. Opinion of process for approving the Company's financial statements

The board of directors is responsible for overseeing. The board of directors appointed a balance sheet committee with the following tasks and composition:

a. Most of the committee members have accounting and financial expertise, and at least one is an external director.

b. The balance sheet committee will discuss the financial statements before they are discussed in the board meeting, and will make recommendations to the board in respect of their approval. The committee will invite the auditors to participate in these discussions. The balance sheet committee will hold discussions and make recommendations to the board as follows: determining accounting policy and defining procedures for financial reporting and recording

c. The balance sheet committee will monitor changes in the accounting regulations and discuss their influence on the Company, discuss issues that will arise in the auditors' audit and discuss changes in the internal reporting systems.

d. The balance sheet committee will monitor and supervise implementation of the accounting policy that was determined and implementation of the regulations that were determined for financial reporting and recording.

e. The balance sheet committee will give an opinion on the abovementioned subjects, and other financial and accounting subjects, when discussing the financial statements and whenever a specific issue arises in a substantial scope in any of the abovementioned subjects.

f. The balance sheet committee will advise the board of directors in the matter of the scope of the auditors' work and their fee.

g. The balance sheet committee will be responsible for the board's contact with the auditors regarding their work.

The financial statements were discussed at the balance sheet committee and submitted to the board of directors for approval. The following officers attended the board discussion: board members – Shlomo Rodav, Eyal Yaniv, Menachem Inbar, Michael Grabiner, Stephen Grabiner, Elon Shalev, Arieh Saban, Kihara R. Kiarie, David Gilboa, Rami Nomkin, Yehuda Porat, Zehavit Cohen, Ran Gottfried and Yitzhak Edelman. In addition, the following officers attended: Avi Gabbay –CEO, Alan Gelman – CFO and Deputy CEO, Bosmat Chelouche – general counsel and Malka Dror – internal auditor. Representatives of Somekh Chaikin also participated in the discussion.

11. Miscellaneous

A. Disclosure concerning the remuneration of the auditor

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	2007 (NIS '000)		2006 (NIS '000)	
			Fee	Hours	Fee	Hours
Bezeq	Somekh Chaikin	Audit Other services	1,785 452	9,000 1,475	2,716 -	11,850 -
Pelephone	Kesselman & Kesselman and Somekh Chaikin	Audit			1,342	5,724
	Somekh Chaikin	Audit Other services	650 57	4,200 152		
DBS	Kesselman & Kesselman and Somekh Chaikin		621	4,300	737	3,754
Bezeq International	Somekh Chaikin and Brightman	Audit Other services	485 124	2,310 590	554 90	3,325 350

The fee in 2006 includes fees for auditing first adoption of International Financial Accounting Standards (IFRS).

B. Following an enquiry of the Securities Authority, it was decided to appoint an external examiner to investigate the issues arising from the Company's immediate reports on March 20, 2007 regarding approval of a stock options plan for employees and managers, on March 26, 2007 regarding approval of bonuses for officers, and on March 26, 2007 regarding restatement – following the letters of the Securities Authority to the Company on March 25, 2007 and March 28, 2007. The findings of the auditor and the subsequent board decisions, including approval of Mr. Yacov Gelbard's notice of the termination of his position as CEO and Mr. Avi Gabbay's entry into the position of CEO, are set forth in Section 2.20 Chapter A of the Periodic Report and the company's immediate statements published since then.

C. On October 25, 2007, the board of directors readopted a code of ethics. The code of ethics establishes principles and rules of conduct to direct the actions of officers, managers and employees. The code of ethics was consolidated in 2005 and a number of amendments and updates were incorporated in its new version. The board of directors authorized the management to act to assimilate the code of ethics in the Company and determined that the code of ethics will be a part of the Company's binding regulations.

D. On September 4, 2007 Shlomo Rodav was appointed chairman of the Company's board of directors. On the same day, the Company's board of directors resolved, pursuant to section 50 (a) of the Companies Law 5759-1999 and Articles 119 and 121.1 of the Articles of Association, that the powers of the CEO in everything relating to the Company's subsidiary companies, whether the holding in them is direct or indirect, (including Pelephone Communications Ltd., Bezeq International Ltd., DBS Satellite Services (1998) Ltd. and Walla! Communications Ltd., Bezeq Zahav Holdings Ltd. and BezeqCall Ltd.) would be transferred to the board of directors and the board of directors adopted the resolutions for implementation of the above.

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

Shlomo Rodav Chairman of the Board of Directors	Avi Gabbay CEO

Chapter C – Financial Statements

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED

DECEMBER 31, 2007

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

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Auditors' Report to the Shareholders of
"Bezeq" The Israel Telecommunication Corp. Limited

We have audited the consolidated balance sheets of "Bezeq" The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2007 and 2006, and the related statements of income, statements of recognised income and expense and cash flows, consolidated, for each of the three years ended on December 31, 2007. These financial statements are the responsibility of the Company's Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of companies which were consolidated, whose assets included in the consolidation constitute approximately 6% of the total consolidated assets at December 31, 2006 and whose revenues included in the consolidation constitute approximately 11% and approximately 10% of the total consolidated revenues for the years ended December 31, 2006 and 2005, respectively. Furthermore, we did not audit the financial statements of associates in which the investment was approximately NIS 37 million and approximately NIS 32 million as at December 31, 2007 and 2006, respectively, and the Group's equity in their profits (losses) is approximately NIS 6 million, approximately NIS 11 million and approximately NIS (3) million, for the years ended December 31, 2007, 2006 and 2005, respectively. The financial statements of those aforementioned consolidated companies and associates were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of those companies, is based solely on the said reports of the other auditors.

In addition we did not audit the financial statements of subsidiaries whose assets were included in the consolidation, according to their restatement in accordance with International Financial Reporting Standards, constitute approximately 30% of the total consolidated assets as at December 31, 2005 and whose revenues included in the consolidation, according to their restatement in accordance with International Financial Reporting Standards, constitute approximately 48% of the total consolidated revenues for the year ended on the aforementioned date. The aforementioned financial statements, prior to their restatement in accordance with International Financial Reporting Standards, were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts included therein, is based solely on the said reports of the other auditors. We audited the adjustments implemented in order to restate the 2005 financial statements in accordance with International Financial Reporting Standards (IFRSs). In our opinion these reconciliations are proper and have been applied properly.

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

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 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 other auditors noted above, the financial statements referred to above present fairly in accordance with International Financial Reporting Standards (IFRSs), in all material respects, the financial position as at December 31, 2007 and 2006 and the results of operations, recognised income and expenses and cash flows for each of the three years ended December 31, 2007. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of annual financial statements), 1993.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters, the maximum possible exposure of which is significant:

1. The intensifying competition, the entirety of changes in the communications market, and the effects of regulation on the Group's financial position and operating results, as described in Note 1.

2. Contingent claims made against the Group of which the exposure cannot yet be assessed or calculated, and other contingencies as described in Notes 17B and 17C.

3. The financial position of a subsidiary, as mentioned in Note 33(3). The subsidiary, as at the date of the financial statements, is not in compliance with the financial stipulations determined in the financing agreement. Subsequent to the balance sheet date the subsidiary is in compliance with the financial criteria at December 31, 2007, subsequent to a relief received from the banks at the same date. The Company has requested the banks to update the stipulations for 2008 in order that they reflect the subsidiary's budget. At the date of approval of the financial statements the banks have approved the subsidiary's request, that the stipulations be updated for 2008. The continuation of the subsidiary's activities is dependent on, inter alia, compliance with the stipulations determined in respect of 2008 and/or further reliefs which will be received during the year. In the opinion of the management of the subsidiary, the sources of finance available to it will be sufficient for the subsidiary's operating requirements for the forthcoming year, this being in accordance with the cash flow forecast approved by the subsidiary's board of directors.

Somekh Chaikin
Certified Public Accountants

March 10, 2008

Consolidated Balance Sheets at December 31

	Note	2007 NIS millions	2006 NIS millions
Assets			
Cash and cash equivalents	5	**1,203**	2,632
Investments and loans, including derivatives	6	**389**	961
Trade receivables	7	**2,403**	2,065*
Other receivables	7	**247**	251
Inventory	3J	**203**	205
Broadcasting rights	3F	**243**	169
Current tax assets		**11**	11
Assets classified as held for sale		**17**	-
Total current assets		**4,716**	6,294
Trade and other receivables	7	**535**	463*
Investments and loans, including derivatives	6	**233**	342
Property, plant and equipment	9	**6,064**	6,492
Intangible assets	10	**2,526**	2,554
Deferred and other expenses	11	**367**	374
Investments in associates accounted by the equity method	12	**37**	32
Deferred tax assets	8	**678**	994
Total non-current assets		**10,440**	11,251
Total assets	28	**15,156**	17,545

	Note	2007 NIS millions	2006 NIS millions
Liabilities			
Loans and borrowings	13	**1,913**	3,637
Trade payables	14	**1,533**	1,393
Other payables, including derivatives	14	**745**	803
Current tax liabilities		**57**	122
Deferred income		**47**	58
Provisions	15	**392**	289
Employee benefits	16	**705**	906
Proposed dividend		**-**	300
Total current liabilities		**5,392**	7,508
Debentures	13	**4,420**	3,170
Obligations to banks	13	**307**	481
Loans from others	13	**136**	169
Loans provided by the minority in a subsidiary	13	**375**	564
Employee benefits	16	**261**	373
Deferred income and others		**36**	37
Provisions	15	**57**	52
Total non-current liabilities		**5,592**	4,846
Total liabilities	28	**10,984**	12,354
Shareholders' equity	20		
Share capital		**6,132**	6,309
Share premium		**-**	1,623
Reserves		**681**	672
Deficit balance		**(2,268)**	(2,849)
Total equity attributable to shareholders of the Company		**4,545**	5,755
Minority equity		**(373)**	(564)
Total shareholders' equity		**4,172**	5,191
Total shareholders' equity and liabilities		**15,156**	17,545

* See Note 3T.

Shlomo Rodav	**Avi Gabbay**	**Alan Gelman**
Chairman of the Board	President & CEO	CFO and Deputy CEO

Date of approval of the financial statements: March 10, 2008.

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

Consolidated Statements of Income for the Year Ended December 31

	Note	2007 NIS millions	2006 NIS millions	2005 NIS millions
Revenue	21	**12,400**	12,232	**11,925**
Costs and expenses				
Depreciation and amortisation	9,10,11	**1,769**	1,864	1,934
Wages	22	**2,375**	2,586	2,586
Operating and general expenses	23	**5,841**	5,967	5,978
Other operating expenses (income), net	24	**79**	250	(100)
		10,064	10,667	10,398
Operating income	28	**2,336**	1,565	1,527
Finance costs	25			
Finance expenses		**796**	694	805
Finance income		**(487)**	(356)	(433)
Finance expenses, net		**309**	338	372
Profit after finance expenses		**2,027**	1,227	1,155
Equity in profits (losses) of associates accounted by the equity method	12	**6**	11	(3)
Profit before income tax		**2,033**	1,238	1,152
Income tax	8	**672**	488	532
Profit for the year		**1,361**	750	620
Attributable to:				
The shareholders' of the Company		**1,330**	809	666
Minority interest		**31**	(59)	(46)
Profit for the year		**1,361**	750	620
Earnings per share	27			
Basic earnings per share (in NIS)		**0.51**	0.31	0.26
Diluted earnings per share (in NIS)		**0.50**	0.31	0.26

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

Consolidated Statements of Recognised Income and Expense for the Year Ended December 31

	Note	2007 NIS millions	2006 NIS millions	2005 NIS millions
Net change in fair value of available-for-sale financial assets	6, 25	**4**	(1)	1
Net change in fair value of available-for-sale financial assets transferred to profit or loss	6, 25	**-**	(5)	(105)
Defined benefit plan actuarial gains (losses)	16	**14**	3	(15)
Income tax on income and expense recognised directly in equity	8	**(4)**	2	41
Income and expenses recognised directly in equity		**14**	(1)	(78)
Profit for the year		**1,361**	750	620
Total recognised income and expense		**1,375**	749	542
Attributable to:				
Shareholders of the Company		**1,344**	808	588
Minority interest		**31**	(59)	(46)
Total recognised income and expense		**1,375**	749	542

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

Consolidated Statements of Cash Flows for the Year Ended December 31

	Note	2007 NIS millions	2006 NIS millions	2005 NIS millions
Cash flows from operating activities				
Net profit for the year		**1,361**	750	620
Adjustments:				
Depreciation	9	**1,482**	1,591	1,666
Amortisation of intangible assets	10	**270**	248	241
Amortisation of deferred and other charges	11	**17**	25	27
Loss (gain) from decrease in holdings in associates accounted by the equity method	12	**1**	(1)	(1)
Share in losses (profits) of associates accounted by the equity method	12	**(6)**	(11)	3
Net financing costs	25	**372**	512*	408*
Net capital gain	24	**(88)**	(159)	(9)
Share-based payment transactions	26	**-**	287	346
Payments to a former senior officer		**6**	-	-
Income tax expenses	8	**672**	488	532
Payment for the removal of derivative financial instruments, net		**(9)**	(27)*	(3)*
Change in inventory		**(6)**	23	78
Change in trade receivables	7	**(437)**	109	(57)
Change in other receivables	7	**4**	(108)	(16)
Change in other payables	14	**(18)**	(14)*	41*
Change in suppliers	14	**36**	(79)	(106)
Change in provisions	15	**105**	27	8
Change in broadcasting rights		**(74)**	(15)	(14)
Change in employee benefits	16	**(300)**	169	(404)
Change in deferred and other income		**(11)**	1*	(13)
		3,377	3,816	3,347
Interest received		**116**	220	177
Dividend received		**3**	26	-
Income tax paid		**(430)**	(277)	(332)
Net cash from operating activities		**3,066**	3,785	3,192
Cash flows from investment activities				
Investment in intangible assets and in deferred expenses	10	**(273)**	(210)	(224)
Proceeds from sale of property, plant and equipment and deferred expenses		**177**	48	21
Investment in financial assets available for sale		**-**	-*	(16)
Financial assets held for trade, net		**647**	1,491	(903)
Purchase of property, plant and equipment	9	**(973)**	(953)	(1,477)
Investment in associates including by way of loans	12	**-**	-	(9)
Proceeds from sale of investments and long-term loans		**66**	63	96
Purchase of investments and long-term loans		**(8)**	(20)*	(4)
Net cash from (used for) investment activities		**(364)**	419	(2,516)

* See Note 3T.

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

Consolidated Statements of Cash Flows for the Year Ended December 31 (contd.)

	Note	2007 NIS millions	2006 NIS millions	2005 NIS millions
Cash flows from financing activities				
Proceeds from issue of debentures	13	**1,814**	-	1,700
Receipt of loans	13	**50**	50	457
Repayment of debentures	13	**(1,927)**	(280)	(267)
Repayment of loans	13	**(840)**	(1,269)	(1,382)
Short-term credit, net	13	**(37)**	43	30
Dividend paid	20	**(2,860)**	(1,600)	-
Interest paid		**(389)**	(602)	(485)
Receipt (payment) for defraying derivative financial instruments		**77**	(76)*	(30)*
Net cash from (used for) financing activities		**(4,112)**	(3,734)	23
Net increase (decrease) in cash and cash equivalents		**(1,410)**	470	699
Cash and cash equivalents at January 1		**2,632**	2,159	1,457
Effect of fluctuations in the rate of exchange on cash balances		**(19)**	3	3
Cash and cash equivalents at December 31	5	**1,203**	2,632	2,159

* See Note 3T.

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

Consolidated Statements of Cash Flows for the Year Ended December 31 - Appendix

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Appendix of non-cash activities			
Purchase of property, plant and equipment and other assets on credit	**183**	142	217
Sale of property, plant and equipment on credit	**126**	162	–

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

NOTE 1 – REPORTING ENTITY

A. Bezeq – The Israel Telecommunication Corp. Ltd. ("the Company") is a company registered in Israel whose shares are traded on the Tel Aviv Stock Exchange. The official address of the Company is 132 Menachem Begin Road, Tel Aviv. The consolidated financial statements of the Company at December 31, 2007 include those of the Company and of its subsidiaries ("the Group"), as well as the rights of the Group in associates. The Group is a principal provider of communications services in Israel (see also Note 28 – Segment Reporting).

B. On October 11, 2005, control in the Company was transferred from the State to Ap.Sb.Ar. Holdings Ltd. and the Company ceased to be a government company. The Company was declared a monopoly in the main areas in which it operates. An appeal filed by the Company was pending in the Antitrust Court against the non-revocation of its monopoly status in basic telephony; however, at the suggestion of the court (in view of the time elapsed since it was filed), the Company consented to withdraw the appeal. All the segments of operation of the Group are in competition. The activities of the Group are, in general, subject to government regulation and control. It is expected that the intensifying competition together with all the changes in the communications market, will have an adverse effect on the business results of the Group – an effect which the Group is unable to estimate.

C. The Company is subject to various sets of laws that regulate and restrict its business activities, including its tariffs. Arrangements pursuant to Sections 15 – 17 of the Communications Law apply to the Company tariffs on services which are prescribed in regulations which are automatically updated in accordance with a linkage formula less an efficiency factor, all as provided in the regulations and relying on the recommendations of public committees which have a mandate to review the Company's tariffs.

NOTE 2 – BASIS OF PRESENTATION

A. Statement of compliance with International Financial Reporting Standards

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRSs"), and in accordance with the Securities (Preparation of annual financial statements) Regulations, 5753-1993.

The Company first adopted IFRSs in 2006, with a transition date of January 1, 2005. The last annual financial statements of the Company prepared in accordance with generally accepted accounting standards in Israel ("Israeli GAAP") were for the year ended December 31, 2005.

B. Definitions

In these financial statements –

(1) the Company – Bezeq The Israel Telecommunication Corp. Limited.

(2) the Group - Bezeq The Israel Telecommunication Corp. Limited and its investee companies, as listed in Note 33 – List of Group Entities.

(3) Subsidiaries – Companies whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Group.

(4) Associates – Companies, including a partnership, in which the Group's investment is stated, directly or indirectly, in the consolidated financial statements on the equity basis.

(5) Investee companies – Subsidiaries or associates.

(6) Related parties – As defined in International Accounting Standards 24 – Related Party Disclosures.

(7) Interested parties – As defined in Paragraph (1) of the definition of "Interested Party" in a corporation, in Section 1 of the Securities Law, 5728-1968.

NOTE 2 – BASIS OF PRESENTATION (CONTD.)

C. Basis of measurement

The consolidated financial statements were prepared on the basis of historical cost except for the following items:

* Derivative financial instruments are measured at fair value.
* Financial instruments at fair value through profit and loss are measured at fair value.
* Available-for-sale financial assets are measured at fair value.
* Liabilities for share-based payment arrangements are measured at fair value.
* Assets stated at deemed cost, as described in Note 9.
* Liabilities in respect of decommissioning sites and the assets to which the liabilities are attributed, as described in Note 15.
* Liabilities in respect of employee benefits, as described in Note 16.

The methods by which the fair value is measured are explained in Note 4.

D. Functional currency of operation and presentation currencies

The consolidated financial statements are stated in New Israel Shekels ("NIS"), which is the functional currency of the Group. The financial information is stated in NIS millions, rounded to the nearest million.

E. Activity in hyper-inflationary economic conditions

Until December 31, 2003, Israel was considered a country with a prevailing hyper-inflationary economy, and accordingly, the non-monetary items in the balance sheet (such as property, plant and equipment (except for property, plant and equipment which was assessed according to deemed cost) intangible assets and capital items) were adjusted for changes in the Consumer Price Index ("the Index") up to that date. From that date onwards, the indexed amounts have served as the basis for the reporting in the subsequent periods.

F. Use of estimates and judgment

When preparing the financial statements, Management is required to make judgments and to avail itself of estimates, assessments and assumptions that affect application of the accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from the estimates used.

The estimates and underlying assumptions are reviewed on an ongoing basis. Changes in the accounting estimates are recognised in the period in which the estimate is revised and in future periods affected by them.

Information regarding significant areas where there is uncertainly in estimates and critical judgements in applying accounting policies that have the most significant effect on the amounts presented in the financial statements is included in the following notes:

*Note 3J	-	Inventory
*Note 7	-	Provision for doubtful debts.
*Note 8	-	Utilisation of losses for tax purposes and deferred tax assets and liabilities recognised.
*Note 9	-	Estimated useful life and residual value of items of property, plant and equipment and determining deemed cost.
*Note 10	-	Measurement of recoverable amounts of cash-generating units.
*Notes 15 and 17	-	Provisions and contingent liabilities.
*Note 16	-	Measurement of a defined benefit obligation and employee benefits.
*Note 26	-	Measurement of share-based payments.
*Note 30	-	Financial instruments.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES

The accounting policies described below have been applied consistently to all periods presented in these consolidated financial statements and in preparing the opening balance sheet at January 1, 2005 (the date of transition to IFRSs), for the purposes of the transition to international reporting standards. The accounting policies were applied consistently by Group entities..

A. Basis of Consolidation

(1) Subsidiaries

Subsidiaries are entitles controlled by the Group. Control exists when the Group has the ability to control the financial and operating policies of an entity in order to achieve benefits from its operations. In assessing control, potential voting rights that are exercisable by the Group are taken into account (see Note 33(3)(b). The financial statements of the subsidiaries are included in the consolidated financial statements from the date that control is acquired until the date that control ceases.

(2) Special-purpose entity

The Company set up a special-purpose entity ("SPE") for investment purposes. SPEs are included in consolidation if, based on an assessment of the substance of its relationship with the Group and the SPEs' risks and rewards, the Group concludes that it controls the SPE. Such an entity controlled by the Group, was established under terms that impose strict limitations on the decision-making powers of the SPE's management and that result in the Group receiving the majority of the benefits related to the SPEs' operations and to the net assets.

(3) Associates (accounted by the equity method)

Associates are those entities in which the Group has significant influence, but not control, over financial and operating policies. Associates are accounted for using the equity method. The consolidated financial statements include the Group's share in the results of investee entities, on an equity accounted basis, after adjustments to align the accounting policies with those of the Group, from the date that significant influence commences until the date that significant influence ceases.

(4) Transactions eliminated on consolidation

Intra-group balances and any unrealised income and expenses arising from intra-group transactions are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with equity accounted investees are eliminated against the investment to the extent of the Group's interest in the investee. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

(5) Minority

The minority shareholders in a consolidated company which has an equity deficit, participated in the losses of that company only up to the amount of the loans of the minority shareholders as presented in the financial statements. The minority interest in the losses of the consolidated company appears as a separate item in equity.

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. The foreign currency gain or loss on monetary items is the difference between the amortised cost in the functional currency at the beginning of the period, adjusted for the effective interest and the payments during the period, and the amortised cost in the foreign currency translated at the exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currencies and measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined. Foreign currency differences arising on the retranslation are recognised in profit or loss, except for differences arising on the retranslation of available-for-sale investments.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Financial Instruments

(1) Non-derivative financial instruments

Non-derivative financial instruments comprise investments in equity and debentures, trade and other receivables, cash and cash equivalents, loans and borrowings, trade and other payables, and also debt securities issued by the Group and loans taken out by the Group.

Non-derivative financial instruments are recognised initially at fair value plus, for instruments not at fair value through profit or loss, any attributable direct costs of the transaction. Subsequent to initial recognition, non-derivative financial instruments are measured as described below.
A financial instrument is recognised when the Group takes upon itself the contractual terms of the instrument. Financial assets are disposed of when the Group contractual rights to the cash flows deriving from the financial assets expire, or when the Group transfers the financial assets to others without retaining control of the asset or is exposed to all the risks and rewards arising from the asset. The acquisition and sale of financial assets performed in the regular way are recognised on the date of the transaction, i.e. on the date on which the Group undertook to acquire or sell the asset. Financial liabilities are disposed of when the Group’s obligation, as detailed in the agreement, expires, or when it is discharged or cancelled.

Cash and cash equivalents
Cash or cash equivalents comprise cash balances and deposits which can be withdrawn on demand (up to three months from the date of their deposit). A bank overdraft which is repayable on demand and forms an integral part of the Group’s cash management, is included as a component of cash and cash equivalents for the purpose of the cash flow statement only.

The accounting treatment of finance income and expenses is described in Note 3O below.

Available-for-sale financial assets
The Group’s investments in shares, certain equity securities and a venture capital fund are classified as available-for-sale financial assets. Subsequent to initial recognition, these investments are measured at fair value, and changes therein, other than accrual of interest, deduction, impairment losses (see Note 3K1) and exchange gains and losses on available-for-sale monetary items (see Note 3B), are recognised directly in equity. When the investment is derecognised, the cumulative gain or loss in equity is transferred to profit or loss.

Investments measured at fair value through profit or loss
A financial instrument is classified as measured at fair value through profit or loss, if it is held for current trading or if the instrument is a derivative.

Index-linked financial instruments
The Group has balances of Index-linked financial instruments. In the opinion of the Group's Management, relaying on the position paper published by the Israel Accounting Standards Board ("IASB"), there are several possible options for the accounting treatment of Index-linked financial instruments. In preparing the financial statements, the Group adopted an accounting treatment whereby the carrying value of the financial instrument and the payments deriving therefrom are revalued in each period according to the actual rate of the rise in the Index. The subject of the measurement of Index-linked financial instruments according to IFRSs is under review, and as part of that review, the professional committee of the IASB approached the accounting treatment of Index-linked liabilities and assets under the International Reporting Standards.

In view of the aforesaid, it might be determined that the above-mentioned accounting treatment is not possible under the provisions of the International Reporting Standards, and that a different treatment – whereby the expectations of inflation should be taken into account when measuring the financial instrument – would be more appropriate (on this matter, see the provisions of AG7 and AG8 of IFRS 39). If this is indeed the decision, the Group will be required to examine the implication, including transition provisions, if determined, on its financial statements as published and will be published until the decision is made according to International standards.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

C. Financial Instruments (contd.)

(2) Derivative financial instruments

The Group holds derivative financial instruments to hedge its foreign currency and Index risks exposure. Embedded derivatives are separated from the host contract and accounted for separately if: (a) the economic characteristics and the risks of the host contract and the embedded derivative are not closely related; (b) a separate instrument with the same terms as the embedded instrument would meet the definition of a derivative, and (c) the combined instrument is not measured at fair value through profit or loss.

Derivatives are recognised initially at fair value: the attributable transaction costs are recognised in profit or loss when incurred. Subsequent to their initial recognition, derivative financial instruments are measured at fair value, and changes therein are recognised through profit or loss.

Economic hedging

Hedge accounting is not applied to derivative instruments that economically hedge monetary assets and liabilities. Changes in the fair value of such derivatives are recognised in profit or loss.

Separable embedded derivatives

Changes in the fair value of separable embedded derivatives are charged immediately in profit or loss.

(3) Share capital – Ordinary shares

Incremental costs directly attributable to the issue of ordinary shares and share options, are recognised as a deduction from equity.

D. Property, plant and equipment

(1) Recognition and measurement

Items of property, plant and equipment are measured at cost less accumulated depreciation and losses from impairment. Certain items of property, plant and equipment that were revalued to fair value on the date of transition to IFRSs, are measured on the basis of their deemed cost, which is the revalued amount at the transition date (January 1, 2005), in accordance with the Group's assessments based on an external appraisal.

Cost includes expenditure that is directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of the materials, direct labour and financing costs, as well as any other costs directly attributable to bringing the asset to a working condition for its intended use by 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. Purchased software that is an integral to the functionality of the related asset, is recognised as part of the cost of that asset.

Where significant 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.

For asset dismantling and removal costs, the Group chose a relief under IFRS1, whereby:

(a) the liability for dismantling and removal at the date of transition to IFRSs is measured in accordance with IAS 37;

(b) the amount that would have been included in the cost of the asset on the date when the liability was first created, is measured by discounting the liability at the same date, according to the historical discount rates; and additionally

(c) the accumulated depreciation is calculated on the same amount at the date of transition to IFRSs.

(2) Subsequent costs

The cost of replacing part of an item of property, plant and equipment item is recognised parting the carrying amount of the item if it is probable that the future economic benefit embodied in the item will flow to the Group and that the cost of the item can be reliably measured. The costs of day to day servicing are recognised in profit and loss as incurred.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

D. Property, plant and equipment (contd.)

(3) Capitalisation of borrowing costs

Costs of non-specific borrowing are capitalised as qualifying assets as defined in IAS 23 – Borrowing Costs, during the period required for completion and construction through the date on which they are ready for their intended use. Non-specific borrowing costs are capitalised for investment in qualifying assets, using a rate which is the weighted average of the rates of cost for those borrowing sources. Other borrowing costs are recognised in profit or loss as incurred.

(4) Depreciation

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful life of each part an item of property, plant and equipment. Leased assets are depreciated over the shorter of the term of the lease and the period of use of the asset.

Improvements made to leased premises are depreciated over the term of the lease, which includes any option for the extension of the lease held by the Group, which it intends to exercise.

The estimated useful lives for the current and comparative periods are as follows:

	Years	Main depreciation %
Digital switching equipment	4-20	10
Transmission and power equipment	5-10	20
Network equipment	5-20	5
Terminal equipment (cellular)	2-3	33
Subscriber equipment and public telephones	5	20
Vehicles	7	15
Internet equipment	4-7	20
Office equipment	5-15	10
Electronic equipment, computers and internal communication systems	3-7	33
Cellular infrastructure equipment	5-10	10
Digital satellite decoders	4-8	17
Broadcasting and reception equipment (satellite)	7	15
Buildings	25	4

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

E. Assets classified as held for sale

Non-current assets which are expected to be realised by way of sale rather than ongoing use, are classified as assets held for sale. These assets are presented according to the lower of book value and fair value, less selling costs. Losses from impairment in value at the time of initial classification of an asset held for sale, and subsequent gains or losses resulting from remeasurement, are recognised in profit or loss. Gains are recognised up to the cumulative amount of loss from impairment in value recorded in the past.

F. Broadcasting rights

Broadcasting rights are stated at cost, net of rights exercised.

Costs of purchased broadcasting rights for screening films and television programmes include the amounts paid to suppliers of rights, plus the direct costs incurred for adaptation of the films and other programs for screening in Israel. The broadcasting rights are depreciated in accordance with the terms of the agreement for their purchase, on the basis of actual screenings out of the total number of screenings permitted under the agreement (where the undepreciated portion at the end of the term of the agreement is depreciated in full upon its termination), or according to the term of the rights agreement.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

G. Intangible assets

(1) Goodwill

Goodwill is created as a result of the acquisition of subsidiaries and associates.

Acquisitions prior to January 1, 2005

As part of the transition to reporting in accordance with IFRSs, the Group chose to account for only those business combinations which occurred after January 1, 2005 in accordance with IFRS 3. Regarding acquisitions prior to January 1, 2005, the goodwill reflects the amount recognised by the Group according to Israeli GAAP. For these acquisitions, the accounting treatment was not adjusted to IFRS 3 in preparing the opening balance sheet of the Group.

Acquisitions subsequent to January 1, 2005

For acquisitions subsequent to January 1, 2005, the goodwill reflects the excess cost of the acquisition over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree.

Subsequent measurement

Goodwill is measured at cost less accumulated impairment losses. In respect of equity accounted investees, the carrying amount of the goodwill is included in the carrying amount of the investment. For assessment of impairment in value, see K(2) below.

(2) Software development costs

Software development costs are capitalised only if the development costs can be measured reliably; the software is technically and commercially applicable; a future economic benefit is expected from the development, and the Group has sufficient resources to complete the development and intends to use the software. A capitalised expense includes the cost of the materials, direct labour and overhead expenses directly attributable to preparation of the asset for its intended use. Other development expenses are recognised in profit or loss as incurred.

Capitalised development costs are measured at cost less amortisation and accumulated losses from impairment.

(3) Subscriber acquisition

Incremental direct sale commissions paid in respect of sales and upgrades to subscribers who have signed a commitment to remain customers, are recognised as an intangible asset. Subscriber acquisition amortisation expenses are recognised in profit or loss over the period of the subscriber's commitment, which is up to 36 months.

(4) Software

The Group's assets include computer systems consisting of hardware and software. Software 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, the licenses for the software, which are a separate item and add functionality to the hardware, are classified (mostly) as intangible assets. The depreciation in respect of software is recognised in profit or loss by the straight-line method, over the estimated useful life of the asset.

(5) Frequency usage rights

Frequency usage rights relate to cellular communication frequencies in respect of which the Group won a tender published by the Ministry of Communications (see Note 18(G) below).

(6) Other intangible assets

Other intangible assets acquired by the Group, which have a defined useful life, are measured at cost less amortisation and accumulated losses from impairment.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

G. Intangible assets (contd.)

(7) Subsequent expenses

Subsequent expenditure is capitalised only when it increases the future economic benefits embodied in the asset to which it relates. All other expenditure, including expenditure relating to amortised goodwill and brands, is recognised in profit and loss as incurred.

(8) Amortisation

Amortisation, except for goodwill, is recognised in profit or loss 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.

The estimated useful lives for the current and comparative periods are as follows:

* Capitalised development expenses	4-7 years
* Other rights	3 and 10 years, depending on the useful life
* Subscriber acquisition costs	Depending on the contractual commitment with the subscriber
* Computer programs and licenses for their use	Over the term of the license or the estimated time of use of the program

H. Leased properties

Leases in which the Group assumes most of the risks and rewards of ownership are classified as finance leases. Upon initial recognition, the leased properties are measured at the lower of the fair value and the present value of the minimum lease payments. Subsequent to the initial recognition, the asset is treated according to the accounting policy applicable to that asset.

Other leases (including leases from the Administration), are classified as operating leases, where the leased properties are not recognized on the balance sheet of the Group.

The Group applies IFRIC 4 – Determining Whether an Arrangement Contains a Lease, which defines criteria for determining, at the commencement of the arrangement, whether a right to use the property constitutes a lease arrangement. In addition, it defines when thereafter the arrangement should be reviewed. The Group applied the relief laid down in IFRS1, whereby the examination of whether an arrangement contains a lease was made on the basis of the facts and circumstances prevailing on January 1, 2005 (the date of transition to IFRSs).

I. Prepaid expenses in respect of a right to use capacities

In accordance with IFRIC 4, as mentioned above, transactions for acquiring an indefeasible right of use (“IRU”) of undersea cable capacities are accounted for as receipt of service transactions. The prepaid expense is amortised on a straight-line basis over the shorter of the term stated in the agreement and the estimated useful life of those capacities (mainly 15 years).

J. Inventory

Inventory is measured at the lower of the cost and net realisable value. The cost of inventory is determined by the moving weighted average method, and includes the expenses of purchasing the inventory and bringing them to their present place and position. The net realisable value is an estimate of the selling price during the normal course of business, less the estimated cost to completion and the estimated costs required for making the sale.

The inventory of a subsidiary includes terminal equipment intended for sale, as well as spare parts used for repairs in the repair service it provides to its customers. As part of its normal operations, the subsidiary upgrades the terminal equipment for its customers, and therefore inventory also includes used handsets and accessories returned by customers.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

K. Impairment

(1) Financial assets

The Group reviews a financial asset for impairment when there is objective evidence that one or more events have impacted negatively on the estimated future cash flows of the asset.

An impairment loss in respect of a financial asset measured at amortised 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.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics. In addition, the financial statements include specific provisions and specific Group provisions for doubtful debts, which properly reflect, according to Management's assessment, the loss inherent in debts whose collection is in doubt.

All the impairment losses recognised in profit or loss. Any cumulative loss in respect of an available-for-sale financial asset, which was formerly charged to capital, is transferred to profit and loss when the asset value became impaired.

An impairment loss is reversed if the reversal can be related objectively to an event that occurred after the impairment loss was recognised. For financial assets measured at amortised cost and available-for-sale financial assets that are debt securities, the reversal is recognised in profit or loss. For available-for-sale financial assets that are equity securities, the reversal is recognised directly in equity.

(2) Non-financial assets

The carrying amounts of the Group's non-financial assets which are not inventory or deferred tax assets, are reviewed at each reporting date to determine whether there are any indications of impairment. If any such indication exists, then the asset's recoverable amount is estimated. On January 1, 2005, the date of transition to the IFRSs, the Group reviewed goodwill for impairment. In subsequent periods, the Group makes an assessment, every year, of the recoverable amount of goodwill and of assets which are not available for use.

An impairment loss is recognised whenever the carrying amount of the asset or its cash-generating unit, exceeds its estimated recoverable amount. A cash-generating unit is the smallest identified group of assets that generates cash flows, irrespective of assets in other groups.

Impairment losses are recognised in profit or loss. Impairment losses which were recognised for cash-generating units are allocated first to reduce the carrying amount of any goodwill attributed to those units, and then to reduce the carrying amount of the other assets in the unit on a pro rata basis.

The recoverable amount of an asset or cash-generating unit is the greater of the value in use and the net selling price (fair value less selling costs). In assessing value in use, the Group capitalises the estimated future cash flows at a pre-tax discount rate, which reflects the market assessments of the time value of the money and the specific risks related to the asset.

An impairment loss in respect of goodwill is not reversed. For other assets, impairment losses which were recognised in prior periods are assessed at each reporting date to determine whether there are any indications that the losses have decreased or no longer exist. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount, only to the extent that the asset's carrying amount after reversal of the impairment loss, does not exceed the carrying amount, net of depreciation or amortisation, that would have been determined if the loss from impairment had not been recognised.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

L. Employee benefits

(1) Post-employment benefits

The Group has a number of post-employment benefit plans. The plans are usually financed by contributions to insurance companies, and are classified as defined contribution plans and as defined benefit plans.

a. Defined contribution plans

The Group's obligation to make contributions to a defined contribution plan, are recognised as an expense in profit or loss on the date on which the obligation to contribute is assumed. (See Note 16D below.)

b. Defined benefit plans

The Group's net obligation in respect of a defined benefit plan for post-retirement benefits is calculated separately for each plan by estimating the future amount of the benefit payable to the employee in return for his service in the current and in prior periods. That benefit is stated at present value less the fair value of the plan's assets and less the cost of past service not yet recognised. The discount rate is the yield at the reporting date on government bonds whose currency and maturity dates are similar to the terms of the Group's obligation. The calculations are made by a qualified actuary using the projected unit credit method. (See Note 16E below.)

Where the benefits of a plan are improved, the portion of the increased benefits relating to past service of employees is recognised in profit or loss on a straight-line basis over the average period until the benefits mature. If the benefits mature immediately, the expense is recognised immediately in profit or loss.

The Group charges immediately, directly to reserves, all the actuarial gains and losses derived from a defined benefit plan.

(2) Other long-term employee benefits

The Group's net obligation in respect of long-term employee benefits, which are not post-employment benefit plans, is the amount of future benefit payable to employees in return for their service in the current and prior periods. The amount of these benefits is discounted to its present value, net of the fair value of the assets related to the obligation. The discount rate is determined according to the yield at the reporting date on corporate bonds in a currency and with a maturity date similar to the terms of the Group's obligation. The calculation is performed using the projected credit unit method. Actuarial gains and losses are recognised in profit or loss in the period in which they arise. (See Note 16F below.)

(3) Severance pay and voluntary retirement benefits

Employee severance pay is recognised as an expense when the Group is demonstrably committed, without realistic possibility of withdrawal, to a formal detailed plan to terminate employment before the normal retirement date. Employee benefits upon voluntary retirement are recognised when the Group proposes a plan encouraging employees to retire voluntarily, the plan is expected to be accepted, and the number of those who will benefit from the plan can be estimated reliably. (See Note 16G and H below.)

(4) Short-term benefits

Obligations in respect of short-term service benefits are measured on a non-discounted basis, and the expense is charged at the time the relevant service is rendered. A provision for short-term service benefits in respect of a cash bonus or a profit-sharing plan, is recognised when the Group has a legal or constructive obligation to pay an amount for a service rendered by the employee in the past, and that amount can be reliably estimated.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

L. Employee benefits (contd.)

(5) Share-based payment transactions

The fair value of options granted to employees is recognised as a salary expense with a corresponding increase in equity, spread over the period during which the employee becomes unconditionally entitled to the options. The amount recognised as an expense is adjusted to reflect the actual number of share options that vest.

The fair value of the options granted to employees by the State in the period when the State was the controlling shareholder of the Company, was recorded as an expense at the time the employees were entitled to the options.

M. Provisions

A provision is recognised 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 at a pre-tax interest rate that reflects current market assessments of the time value of the money and the risks specific to the liability.

(1) Contingent liabilities

The financial statements include appropriate provisions in respect of claims against the Group companies which, in the opinion of those companies, will not be dismissed or abated even though the claims are denied by the Group companies. In addition, there are also a small number of legal proceedings which have been received recently, the risks of which cannot be assessed at this stage and for which, therefore, no provisions have been made.

The treatment of contingent legal claims is according to IAS 37 and its related provisions. Accordingly, the claims are classified by likelihood of realisation of the exposure to risk, as follows:

a. More likely than not – more than 50% probability.
b. Possible – probability more than unlikely and less than 50%
c. Unlikely – probability of 10% or less.

For claims which are more likely than not, the financial statements include provisions which in the opinion of the Group's managements, based, *inter alia*, on the opinions of its legal advisers retained in respect of those claims, are appropriate to the circumstances of each case.

Note 17A includes details of the additional exposure due to contingent claims whose amounts are significant, and in which the likelihood of realisation is possible or remote.

(2) Reorganisation

A provision for reorganisation is recognised when the Group has approved a detailed and formal reorganisation plan, and the reorganisation has either commenced or has been announced. Future operating costs are not provided for.

(3) Onerous contracts

A provision for onerous contracts is recognised when the expected benefits to be derived by the Group from a contract are lower than the unavoidable cost of meeting its 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 the contract.

(4) Site dismantling and clearing costs

A provision in respect of an obligation to dismantle and clear sites is accrued in accordance with IAS 37. The provision is accrued 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. In connection with accrual of a provision for the costs of dismantling and clearing sites at the date of transition to IFRSs, the Group selected the relief in accordance with IFRS1, as described in Note 3D(1).

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

M. Provisions (contd.)

(5) Warranty
A subsidiary recognised 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.

N. Revenue

The Group's revenue consists mainly of revenue from fixed-line communication services, cellular services, international communication services, satellite television services, customer centre services, provision of communication services to other communications providers, sale and installation of communications equipment, and internet services. Revenue is measured at the fair value of the consideration received or about to be received, less returns, commercial discounts and quantity discounts.

(1) Equipment sales
Revenue from sales of equipment is recorded at the time of shipment to the customer, upon transfer of the significant risks and rewards related to ownership of the equipment sold.

(2) Services
Revenue from services rendered is recognised proportionately over the term of the agreement or upon providing the service if the flow of the economic benefits associated with providing the service is certain. Revenue from calls, including revenue from prepaid call cards, is recognised when the call is made by the customer.

(3) Sales on credit
Revenue from credit sales transactions that include a financing transaction are recorded at their present value, so that the difference between the fair value of the transaction and the stated amount of the consideration will be recognised in the income statement as interest income, using the effective interest rate.

(4) Multi-component sale agreements
Revenues from sale agreements that do not contain a general right of return, which include a number of components, such as an appliance, service, and support agreements, are split into separate accounting units and recognised separately for each accounting unit. A component constitutes a separate accounting unit if, and only if, it has a separate value for the customer and in addition, there is reliable and objective evidence of the fair value of all the components in the agreement / the fair value of the components not yet supplied. Components not split into an accounting unit due to non-compliance with the conditions described above, are grouped together into one accounting unit. Recognition of revenues from the various accounting units takes place when the conditions are met for recognition of revenues from the components in that accounting unit, depending on their type, and only up to the amount of the consideration which is not contingent upon completion / performance of the other components in the contract.

(5) Gross or net-based income reporting
When the Group acts in the capacity of an agent or broker without bearing the risks and rewards deriving from the transaction, its income stated net. Conversely, where the Group acts as a main supplier and bears the risks and rewards deriving from the transaction, its income is stated gross.

(6) Lease of satellite decoders
A subsidiary collects deposits for digital satellite decoders held by its customers, in an amount which does not exceed the cost of the decoders. At the end of the agreement the customers are entitled to the remaining portion of the deposit in accordance with their agreement. Revenues from deduction of the deposits are recorded in profit or loss, in accordance with the terms of the agreement with the customers.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

O. Finance income and expenses

Finance income includes interest income in respect of amounts invested, income from dividends, interest income from releasing deferred income in respect of the sale of terminal equipment in instalments, gains from the sale of available-for-sale financial assets, changes in the fair value of financial assets stated at fair value through profit or loss, gains from foreign currency and gains from hedging instruments that are recognised in profit or loss. Interest income is recognised as it accrues, using the effective interest method. Dividend income is recognised on the date on which the Company's right to receive payment is established, which in the case of quoted securities is usually the ex-dividend date.

Financing expenses comprise interest expense on borrowings, debentures issued, commissions paid, changes in the time value in respect of provisions, foreign currency losses, changes in the fair value of financial assets stated at fair value through profit or loss, losses from impairment of financial assets (except for a provision for doubtful debts, which is stated in operating and general expenses), and losses from hedging instruments recognised in profit or loss. All borrowing costs are charged to profit or loss using the effective interest rate.

P. Income tax expense

Income tax expense comprises current and deferred taxes and is recognised in profit or loss except to the extent that it relates to a transaction or event recognised directly in equity, in which case it charged to equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Recognition of deferred taxes is by the equity method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for tax purposes. The Group does not recognise deferred taxes for the following temporary differences: initial recognition of goodwill, initial recognition of assets and liabilities in a transaction which is not a business combination and which does not affect accounting profit or taxable profit, losses carried forward which are nor expected to be utilised in the foreseeable future, and differences arising from investment in subsidiaries if they are not expected to be reversed in the foreseeable future. The deferred taxes are measured using the tax rates expected to be applicable to the temporary differences on the date of their realisation, based on the laws enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognised if it is probable that future taxable profits will be available against which the deductible temporary differences can be utilised. Deferred tax assets are reviewed at each reporting date and are reduced if the related tax benefit is not expected to be realised.

Q. Earnings per share

The Group presents basic and diluted earnings per share (EPS) data in respect of its ordinary shares. The basic earning per share is calculated by dividing the profit or loss attributable to the ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period. The diluted earning per share is determined by adjusting the loss or gain attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, which comprise convertible notes, share options and share options granted to employees.

R. Segment reporting

A segment is a distinguishable component of the Group that is engaged in providing related services (business segment), and which is subject to risks and rewards that differ from those of the other segments. The Group's primary format for segment reporting is based on business segments. The business segments are determined by the Group's Management according to the internal reporting structure.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

S. Dividend declared subsequent to the balance sheet date

An obligation relating to a dividend proposed or declared after the balance sheet date is recognised only in the period in which the declaration was made.

T. Classified amounts

The financial statements include reclassification of certain amounts of the comparative figures of for the relevant sections.

U. New standards and interpretations not yet adopted

A number of new standards, amendments to existing standards and interpretations, were not yet effective on December 31, 2007, and therefore have not been applied in the preparation of these consolidated financial statements.

(1) IFRS 8 – Segment Reporting, describes how a corporation should report on segment operations in the annual financial statements, and relates to selected details concerning segments in interim reports. In addition, the standard relates to the disclosure required for products and services, geographical areas and principal customers. The standard allows the corporation to determine the rationale for division into segments, so that segment reporting will be based on factors under management's supervision for operational decision-making. The standard will apply to annual periods commencing on January 1, 2009 or thereafter. The standard permits early application, and requires amendment of comparative numbers upon adoption of the standard. The adoption of IFRS 8 is not expected to impact the Group's financial statements.

(2) Amended IAS 23 – Borrowing Costs. The amendment revokes the option to recognise all borrowing costs immediately to profit or loss if specific borrowing costs were incurred from the acquisition, erection or production of a recognised asset. The amendment requires that such costs be capitalised as part of the total cost of the asset. The other borrowing costs will be recognised in profit or loss as incurred. The standard will come into force on January 1, 2009, and is not expected to impact the Group's financial statements.

(3) Amended IAS 1 – Presentation of Financial Statements, presents the term "comprehensive income" (i.e. changes in equity during the period, except for changes deriving from transactions with shareholders by virtue of their being shareholders). The provisions for application of the amended standard include a specimen statement of comprehensive income in one statement or two. The standard also prohibits the presentation of components or comprehensive income in the statement of changes in equity. IAS 1 will apply to the Group's 2009 financial statements, and is not expected to impact them except regarding presentation.

(4) IAS 27 (2008) – Consolidated and Separate Financial Statements, reflects changes in the accounting treatment of the rights of non-controlling (minority) shareholders, and deals mainly with the accounting treatment of changes in ownership rights in subsidiaries after the acquisition of control, the accounting treatment upon loss of control in subsidiaries, and the allocation of profit or loss to those with and without controlling rights in a subsidiary. IAS 27 will apply to the Group's 2010 financial statements. The Group's Management is considering the impact of the standard on the financial statements, including the possibility of early application.

(5) IFRS 3 (2008) – Business Combinations, also deals with business combinations made by contract only; the definition of a business combination focuses on attaining control; including contingent consideration; the acquirer can choose to measure the rights which do not grant control at their fair value on the date of acquisition or according to its relative part in the fair value of the identifiable assets and the identifiable liabilities of the acquiree; where acquisition is achieved by means of step acquisition, the identifiable assets and liabilities of the acquiree are recognised at their fair value when control is achieved. IFRS 3 (2008) will apply to the Group's 2010 financial statements.. The Group is considering the effects of the standard on the financial statements, including the possibility of early application.

NOTE 3 – SIGNIFICANT ACCOUNTING POLICIES (CONTD.)

U. New standards and interpretations not yet adopted (contd.)

(6) IFRS 2 – Share-Based Payment – Vesting Conditions and Cancellations, clarifies the vesting conditions to be reflected in the fair value at the grant date, and explains the accounting treatment of instruments that have no vesting period, and forfeitures. IFRS 2 will apply to the Group's 2009 financial statements , and at this stage, Management does not expect it to impact the Group's financial statements.

(7) IFRIC 11 – Group and Treasury Share Transactions. The interpretation deals with share-based transactions related to the Company's equity instruments. IFRIC 11 will apply for annual periods commencing March 1, 2007 or thereafter. The adoption of IFRIC 11 is not expected to influence the financial statements of the Group.

(8) IFRIC 12 – Segment Reporting Arrangements, is an interpretation dealing with the accounting treatment of operators from the private sector which provide public infrastructure assets and services. IFRIC 12 creates a distinction between two types of arrangements for service concessions: in one, the operator receives a financial asset, an unconditional contractual right to receive cash or other financial asset from the government in exchange for the construction or upgrading of a public asset; in the other, the operator receives an intangible asset, a right to collect payment for the use of the public asset it is constructing or upgrading. The right to collect payment from users is not an unconditional right to receive cash, since the amounts depend on how much use the public will use the service. The interpretation will apply to annual periods commencing on January 1, 2008, or thereafter, and early adoption is permitted. The adoption of IFRIC 12 is not likely to impact the Group's financial statements.

(9) IFRIC 13 – Customer Loyalty Programmes. The interpretation addresses the accounting of companies that grant benefits as part of customer loyalty programmes (such as "points" or "frequent flyer" programs) when goods or services are purchased. IFRIC 13 explains how companies should treat an obligation to supply goods or services in the future free of charge or at a discount (benefits) to customers who are expected to utilise the benefits. The interpretation will apply to annual periods commencing July 1, 2008 or thereafter. The adoption of IFRIC 13 is not expected to impact the Group's financial statements.

(10) IFRIC 14 – The Limit on a Defined Benefit Asset, is the interpretation relating to IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction. The interpretation clarifies three subjects:
(a) when the reductions in future funding or returns are considered "available" in the context of Section 58 of IAS19;
(b) how minimum funding requirements affect the availability of future reductions in funding;
(c) when minimum funding requirements might generate a liability.
The Interpretation will apply to annual periods commencing January 1, 2008 or thereafter. The adoption of IFRIC 14 is not expected to impact the Group's financial statements.

NOTE 4 – DETERMINING FAIR VALUE

Accounting policies and disclosure requirements require the Group to determine the fair value of monetary and non-monetary assets and liabilities. The fair values were determined for the purposes of measurement and/or disclosure using the methods described below. Additional information regarding the assumptions used in determining the fair values can be found in the notes relevant to the particular asset or liability.

A. Property, plant and equipment

Certain items of property, plant and equipment were revalued on the date of transition to IFRSs. Determination of the deemed cost of the items is based on an assessment of the value performed by an external appraiser using the depreciated replacement cost method.

NOTE 4 – DETERMINING FAIR VALUE (CONTD.)

B. Investments in shares and debentures

The fair value of monetary assets measured at fair value through profit and loss, which are classified as available for sale, is determined using their selling price in the market or according to a model for non-negotiable assets at the balance sheet date.

C. Customers and other trade receivables

The fair value of customers and other long-term trade receivables was determined using the present value of the future cash flows, discounted at the market interest rate at the balance sheet date.

D. Derivatives

The fair value of forward contracts on foreign currency or the Index is based on their quoted market prices, if available, and if unavailable, particularly regarding embedded derivatives, according to estimated value.

E. Non-derivative financial liabilities

The fair value, which is determined for disclosure, is calculated at the present value of the future cash flows in respect of the principal and the interest, discounted at the market interest rate at the balance sheet date.

F. Share-based payments

The fair value of stock options for employees is measured using the Black and Scholes model. The assumptions of the model include the share price at the date of measurement, the exercise price of the instrument, expected volatility (based on the weighted average of historical volatility, adjusted for changes expected from information available to the public), the weighted average of the projected useful life of the instruments (based on past experience and the general behaviour of the option-holders), expected dividends, and the risk-free interest rate (based on government bonds). Conditions of service and performance which are not market conditions, are not taken into account in determining the fair value. Conditions which are not vesting conditions are taken into account in calculating the fair value. See also Note 26.

NOTE 5 – CASH AND CASH EQUIVALENTS

	December 31 2007	December 31 2006
	NIS millions	NIS millions
Bank balances	**55**	66
Demand deposits	**1,148**	2,566
Cash and cash equivalents	**1,203**	2,632

The effective interest rate on the demand deposits in 2007 was 3.3% - 5.0% (2006 – 4.8% - 5.3%). For deposits, the average maturity period was 6-8 days (2006 – 3-7 days).

NOTE 6 – INVESTMENTS AND LOANS, INCLUDING DERIVATIVES

A. Segmentation by investment classification

	December 31 2007	December 31 2006
	NIS millions	NIS millions
Current investments		
Financial assets measured at fair value through profit and loss[(1)]	**294**	894
Structured instruments[(2)]	**-**	61
Financial assets available for sale	**47**	-
Derivatives	**45**	3
Other investments	**3**	3
	389	961
Non-current investments		
Bank deposit for providing loans to employees[(3)]	**149**	185
Financial assets available for sale	**68**	121
Loans and long-term debit balances	**-**	36
Derivatives	**16**	-
	233	342
	622	1,303

(1) **Sensitivity analysis – negotiable financial assets price risk**

All of the Group's investments in securities are listed for trading on the stock exchange.

A rise of 1% in the market value of the investments at the reporting date would increase the profit and the equity by NIS 2 million after tax (2006 – an increase of NIS 6 million). A similar change downwards would decrease the profit and the equity by the same amounts.

(2) The carrying value in 2006 of embedded instruments includes debentures. The instruments are dollar-linked and bear LIBOR for six months and three months plus a margin of 3.4% and 1.65% respectively.

(3) 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, 2007 is 2.8% (2006 – 2.93%). The Company is liable for the loans to the employees. The deposit is stated at its present value, taking into account loan repayment schedule, based on a weighted average discount rate of 5.15% (2006 – 5.56%). Deferred salary expenses are added to the deposit amount.

NOTE 6 – INVESTMENTS AND LOANS, INCLUDING DERIVATIVES (CONTD.)

B. Segmentation by types of securities

	December 31, 2007			December 31, 2006		
	Marketable	Others	Total	Marketable	Others	Total
	Equity value	Equity value	Equity value	Equity value	Equity value	Equity value
		NIS millions			NIS millions	
Government bonds –						
Index-linked	**86**	**-**	**86**	189	-	189
Unlinked	**71**	**-**	**71**	201	-	201
Dollar-linked	**-***	**-**	**-***	-*	-	-*
Corporate debentures	**74**	**-**	**74**	329	-	329
Foreign securities	**12**	**-**	**12**	55	-	55
Short-term loan	**8**	**-**	**8**	88	-	88
Investments in shares and options	**31**	**68**	**99**	29	75	104
Participation in trust funds	**15**	**-**	**15**	8	-	8
Investments in debentures convertible to shares	**1**	**-**	**1**	2	-	2
Structured instruments	**-**	**-**	**-**	-	61	61
Bank deposit for providing loans to employees	**-**	**149**	**149**	-	185	185
Investment in hedge fund	**-**	**43**	**43**	-	39	39
Loans and long-term debit balances	**-**	**-**	**-**	-	36	36
Derivatives	**-**	**61**	**61**	-	3	3
Other investments	**-**	**3**	**3**	-	3	3
	298	**324**	**622**	901	402	1,303

* Less than NIS 500,000.

C. Linkage basis and interest terms – non-current investments*

	December 31, 2007				
	Interest %	Unlinked	Index-linked	Linked to foreign currency	Total
		NIS millions	NIS millions	NIS millions	NIS millions
Deposit in bank for providing loans for employees	2.8%	**149**	**-**	**-**	**149**
Derivatives	Interest-free	**-**	**16**	**-**	**16**
		149	**16**	**-**	**165**

	December 31, 2006				
	Interest %	Unlinked	CPI-linked	Linked to foreign currency	Total
		NIS millions	NIS millions	NIS millions	NIS millions
Deposit in bank for providing loans for employees	2.93%	185	-	-	185
Capital notes	5.85%	-	16	-	16
Loan	6.25%	-	20	-	20
Financial asset available for sale	Interest-free	-	-	39	39
		185	36	39	260

* Not including non-negotiable shares.

NOTE 7 – TRADE AND OTHER RECEIVABLES

	December 31 2007	December 31 2006
	NIS millions	NIS millions
Trade receivables		
Trade receivables that are related parties and interested parties	**113**	98
Outstanding debts	**893**	778*
Credit vouchers and checks receivable	**460**	455
Income receivable	**361**	291*
Current maturities of long-term trade receivables[2]	**576**	443
	2,403	2,065
Receivables		
Prepaid expenses	**80**	94
Other receivables	**167**	157
	247	251
Long-term trade receivables[1][2]	**535**	435*
Other long-term receivables[1]	**-**	28
	535	463
	3,185	2,779

Trade and other receivables denominated in a currency which is not the functional currency include NIS 84 million denominated in US dollars (2006 – NIS 60 million), and NIS 391,000 denominated in euro (2006 – NIS 7 million).

(1) For the repayment dates and the discounted interest rates, see Note 30.

(2) **Sensitivity analysis – Interest risk**
An increase of 10% in nominal shekel interest would reduce the fair value by approximately NIS 8 million. A similar change in the opposite direction would increase the fair value by the same amount.

* See Note 3T

Following is the trade receivables aging at the reporting date

	December 31 2007	December 31 2006
	NIS millions	NIS millions
Not in arrears	**2,566**	2,189
One year's arrears	**385**	358
Arrears between one and two years	**128**	118
Arrears of over two years	**187**	174
	3,266	2,839
Less the provision for doubtful debts	**328**	339*
	2,938	2,500

NOTE 7 – TRADE AND OTHER RECEIVABLES (CONTD.)

Movement in provision for doubtful debts during the year

	December 31 2007	December 31 2006
	NIS millions	NIS millions
Balance at January 1	**339**	385
Change during the year, net	**(11)**	(46)
Balance at December 31	**328**	339*

* See Note 3T.

NOTE 8 – INCOME TAX

A. General

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Current tax expenses			
In respect of the current period	**365**	397	308
Adjustments in respect of prior years	**(5)**	5	(29)
	360	402	279
Deferred tax expense			
Reduction in the tax rate	**-**	-	83
Creation and reversal of temporary differences	**312**	91	195
Changes in the value of temporary differences not recognised	**-**	(5)	(25)
	312	86	253
Income tax expense from ongoing activities	**672**	488	532

B. Reconciliation of effective tax rate

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Net profit	**1,361**	750	620
Income tax	**672**	488	532
Profit before tax	**2,033**	1,238	1,152
Statutory tax rate	**29%**	31%	34%
Income tax at the local tax rate applicable to the Group	**590**	384	392
Differences in the tax rate	**34**	8	83
Differences in definition of capital and assets	**(39)**	(6)	(60)
Expenses not recognised for tax purposes	**52**	15	48
Recognition of losses for tax purposes not recognised in the past	**-**	-	5
Deferred taxes in respect of temporary differences not recognised in the past	**-**	(5)	(25)
Losses generated in the period, for which a deferred tax asset was not recognised	**28**	88	129
Agreed tax assessments	**-**	-	(8)
Losses of a partnership	**-**	1	(4)
Change in temporary provisions not recognised	**(1)**	(4)	(12)
Taxes in respect of prior years	**(5)**	5	(29)
Others	**13**	2	13
	672	488	532

NOTE 8 – INCOME TAX (CONTD.)

C. Income tax attributable directly to equity

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Available-for-sale financial assets	**4**	(6)	(104)
Actuarial gains and losses	**14**	3	(15)
Expenses recognised directly in equity	**18**	(3)	(119)
Total tax recognised directly in equity	**(4)**	2	41

D. Deferred tax assets that were not recognised

The calculation of deferred taxes does not take into account the taxes that would be applicable in case of realisation of the investment in subsidiaries and associates, since the Group intends to retain the investment. Deferred taxes in respect of a distribution of profit in subsidiaries and associates were also not taken into account, since the dividends are not taxable. In addition, unutilised deferred tax assets in respect of losses carried forward and tax assets carried forward, were not recognised in cases where future taxable income against which they can be utilised, is not foreseen.

Deferred tax assets not recognised

Deferred tax assets were not recognised in respect of the following items

	2007	2006
	NIS millions	NIS millions
Deductible temporary differences	**3**	18
Losses for tax purposes	**96**	225
	99	243

Under existing tax laws, there is no time limit on utilising tax losses or on utilising deductible temporary differences. Deferred tax assets were not recognised in respect of these items since it is not anticipated that there will be taxable income against which the tax benefits can be utilised. The balance of unrecognised deferred tax assets in respect of losses for tax purposes is approximately NIS 902 million.

NOTE 8 – INCOME TAX (CONTD.)

E. Recognised tax assets and deferred tax liabilities

Tax assets and deferred tax liabilities are attributed to the following items

	Assets		Liabilities		Net	
	2007	2006	2007	2006	2007	2006
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Property, plant and equipment	**58**	57	**116**	70	**(58)**	(13)
Doubtful debts	**50**	51	**-**	-	**50**	51
Intangible assets	**-**	-	**13**	10	**(13)**	(10)
Monetary assets measured at fair value through profit and loss	**3**	4	**-**	2	**3**	2
Available-for-sale financial assets	**3**	3	**2**	1	**1**	2
Derivatives	**-**	-	**-**	-*	**-**	-*
Employee benefit plan	**418**	547	**-**	-	**418**	547
Share-based payments	**136**	136	**-**	-	**136**	136
Provisions	**51**	5	**-**	-	**51**	5
Other assets	**2**	11	**-**	-	**2**	11
Deferred expenses in connection with agreed assessments	**4**	9	**-**	-	**4**	9
Losses from partnerships	**-**	3	**-**	-	**-**	3
Tax losses carried forward	**84**	251	**-**	-	**84**	251
	809	1,077	**131**	83	**678**	994

* Less than NIS 500,000.

NOTE 8 – INCOME TAX (CONTD.)

F. Changes in temporary differences during the year

	Balance at January 1, 2006	Charged to profit and loss	Charged to equity	Balance at December 31, 2006	Charged to profit and loss	Charged to equity	Balance at December 31, 2007
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Property, plant and equipment	87	(100)	-	(13)	**(45)**	**-**	**(58)**
Doubtful debts	65	(14)	-	51	**(1)**	**-**	**50**
Intangible assets	(5)	(5)	-	(10)	**(3)**	**-**	**(13)**
Financial assets measured at fair value through profit and loss	(12)	14	-	2	**1**	**-**	**3**
Financial assets available for sale	4	(4)	2	2	**-**	**(1)**	**1**
Derivatives	-*	-*	-	-*	**-***	**-**	**-***
Employee benefits	480	67	-	547	**(126)**	**(3)**	**418**
Share-based payments	64	72	-*	136	**-**	**-**	**136**
Provisions	6	(1)	-	5	**46**	**-**	**51**
Deferred expenses in connection with other items	10	1	-	11	**(9)**	**-**	**2**
Agreed assessments	14	(5)	-	9	**(5)**	**-**	**4**
Losses from partnerships	-	3	-	3	**(3)**	**-**	**-**
Losses carried forward for tax purposes	365	(114)	-	251	**(167)**	**-**	**84**
	1,078	(86)	2	994	**(312)**	**(4)**	**678**

* Less than NIS 500,000.

NOTE 8 – INCOME TAX (CONTD.)

G. Amendments to the Income Tax Ordinance

On July 25, 2005, the Knesset passed the Amendment to the Income Tax Ordinance (Number 147 and temporary order) Law, 5765-2005 ("Amendment 147"). Amendment 147 provides for a gradual reduction in the corporate tax rate in the following manner:
In the 2006 tax year, the corporate tax rate will be 31%, in 2007 the rate will be 29%, in 2008 – 27%, in 2009 – 26% and from 2010 and thereafter, the corporate tax rate will be 25%. In addition, commencing in 2010 and with the reduction in the company tax rate to 25%, any real capital gain will be taxed at 25%.

Current taxes and deferred tax balances at December 31, 2006 and at December 31, 2007 are calculated at the new tax rates as provided in Amendment 147. The effect of the change on the consolidated financial statements at the beginning of 2005 is an increase in the income tax expense in the income statement and a decrease in the deferred taxes included in the balance sheet in the amount of NIS 83 million consolidated.

H. Adjustments Law

Under the Income Tax (Adjustments for inflation) Law, 5745-1985 ("the Adjustments Law"), taxable results are measured on a real basis, taking into account the rate of change in the Index. The Group is assessed on the basis of this law.

On February 26, 2008 the Knesset enacted the Income Tax Law (Adjustments for Inflation) (Amendment No. 20) (Restriction of Effective Period) – 2008 (hereinafter – the Amendment). In accordance with the Amendment, the effective period of the Adjustments Law will cease at the end of the 2007 tax year and as from the 2008 tax year the provisions of the law shall no longer apply, other than the transitional provisions intended to prevent distortions in the tax calculations.

In accordance with the Amendment, as from the 2008 tax year, income for tax purposes will no longer be adjusted to a real (net of inflation) measurement basis. Furthermore, the depreciation of inflation immune assets and carried forward tax losses will no longer be linked to the CPI, so that these amounts will be adjusted until the end of the 2007 tax year after which they will cease to be linked to the CPI.
,

In 2007, with annual inflation of 3.4%, the effects of the Adjustments Law, mainly an addition due to inflation and a deduction due to depreciation, led to a decrease of approximately NIS 39 million in the tax expenses of the Company.

I. Final tax assessments

(1) The Company, Bezeq International, Pelephone and Bezeq On Line have final assessments up to and including 2003.

(2) In December 2007, an inactive company wholly owned by Pelephone received best-judgment tax assessments for the years 2003-2005. The amount of the assessments is NIS 31 million. Pelephone has filed an objection to these assessments.

(3) DBS has received final tax assessments up to and including 2004.

NOTE 9 – PROPERTY, PLANT AND EQUIPMENT

A. Composition and movement

	Land and buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
				NIS millions			
Cost or deemed cost							
Balance at January 1, 2006	2,041	3,949	12,152	2,836	149	1,223	22,350
Additions	25	350	104	320	1	108	908
Disposals (d below)	(116)	(357)	(36)	(141)	(39)	(105)	(794)
Balance at December 31, 2006	1,950	3,942	12,220	3,015	111	1,226	22,464
Balance at January 1, 2007	1,950	3,942	12,220	3,015	111	1,226	22,464
Additions	**79**	**477**	**108**	**325**	**1**	**112**	**1,102**
Disposals (d below)	**(85)**	**(268)**	**(45)**	**(57)**	**(32)**	**(53)**	**(540)**
Transfer to assets held for sale	**(54)**	**-**	**-**	**-**	**-**	**-**	**(54)**
Balance at December 31, 2007	**1,890**	**4,151**	**12,283**	**3,283**	**80**	**1,285**	**22,972**
Depreciation and losses from impairment							
Balance at January 1, 2006	1,404	1,362	9,484	1,869	115	869	15,103
Depreciation for the year	104	693	277	373	14	130	1,591
Disposals (D below)	(83)	(354)	(36)	(111)	(35)	(103)	(722)
Balance at December 31, 2006	1,425	1,701	9,725	2,131	94	896	15,972
Balance at January 1, 2007	1,425	1,701	9,725	2,131	94	896	15,972
Depreciation for the year	**98**	**621**	**261**	**359**	**6**	**137**	**1,482**
Disposals (D below)	**(73)**	**(266)**	**(45)**	**(43)**	**(29)**	**(50)**	**(506)**
Transfer to assets held for sale	**(40)**	**-**	**-**	**-**	**-**	**-**	**(40)**
Balance at December 31, 2007	**1,410**	**2,056**	**9,941**	**2,447**	**71**	**983**	**16,908**
Carrying value							
At January 1, 2006	637	2,587	2,668	967	34	354	7,247
At December 31, 2006	525	2,241	2,495	884	17	330	6,492
At December 31, 2007	**480**	**2,095**	**2,342**	**836**	**9**	**302**	**6,064**

NOTE 9 – PROPERTY, PLANT AND EQUIPMENT (CONTD.)

A. Composition and movement (contd.)

a. Determination of fair value as deemed cost – Certain items of property, plant and equipment from the switching, transmission and power group of equipment, principally switching equipment, which were revalued to fair value on the date of transition to the IFRSs, were measured on the basis of their deemed cost, which was determined according to their fair value on the transition date (January 1, 2005), as assessed by the Group based on valuation an external appraiser. The assessments were attached to the financial statements of the Group at December 31, 2006.

b. Residual value – The residual value of the Group's copper cables as assessed at the end of the reporting year. The residual value is approximately NIS 591 million and NIS 598 million at December 31, 2007 and December 31, 2006 respectively.

c. Cost of dismantling and removal of assets – The cost of items of property, plant and equipment includes dismantling and removal costs, as well as other restoration costs to which the Group has an obligation. These costs are depreciated according to the expected useful life of the sites. During 2007, the Group capitalised costs of approximately NIS 4 million for dismantling and removal of assets (2006 – NIS 1 million).

d. Property, plant and equipment in the Group is removed at the year end upon reaching full depreciation, except for land, buildings and vehicles, which are removed on their sale. In 2007, the Group removed fully depreciated property at a cost of approximately NIS 385 million (2006 – NIS 565 million).

e. The cost includes approximately NIS2 million in the Group, representing real financing expenses which were capitalised in the reporting period in respect of loans and credit in the construction period and calculated at a real average interest rate of approximately 6.78% per year (prior year – 4.3%).

f. At December 31, 2007, Pelephone has a commitment to purchase terminal equipment during 2008, for a total amount of NIS 242 million.

g. In November 2007, the general meting of Pelephone adopted the resolution of Pelephone's board of directors concerning the erection of a HSPA/UMTS network for one billion shekels. The new network is scheduled to start operation at the beginning of 2009. The investment in the network will be spread over four years (mainly in 2008).

h. At the balance sheet date, there are agreements to purchase property, plant and equipment totalling approximately NIS 348 million consolidated, which includes sub-sections f. above.

i. Concerning liens, see Note 19.

j. The useful life of the property, plant and equipment was reviewed by the Depreciation Committee of the Group companies, in order to estimate the useful life of their equipment.

The main findings of the review are as follows:

(1) In infrastructure and communications equipment a change was made in the estimate, as a result of which the depreciation expense decreased in 2007 by approximately NIS 7 million, in 2008 it will decrease by approximately NIS 24 million, and in 2009 it will decrease by approximately NIS 7 million.

(2) In Pelephone's network equipment (see g. above), a change was made in the estimate, as a result of which the depreciation expense in 2007 increased by approximately NIS 5 million, in 2008 it will increase by approximately NIS 10 million, and in 2009 it will increase by approximately NIS 2 million.

NOTE 10 – INTANGIBLE ASSETS

	Goodwill	Computer software and licenses and discounted development costs	Subscriber acquisition, net	Right of use in frequencies	Others	Total
	NIS millions					
Cost						
Balance at January 1, 2006	1,793	1,174	226	220	50	3,463
Acquisitions as part of business combinations	*-	-	-	-	-	*-
Developed by the Group or purchased separately	-	147	49	-	*-	196
Deductions (1)	-	(74)	-	-	-	(74)
Balance at December 31, 2006	1,793	1,247	275	220	50	3,585
Balance at January 1, 2007	1,793	1,247	275	220	50	3,585
Acquisitions as part of business combinations	**6**	**-**	**-**	**-**	**-**	**6**
Developed or purchased separately by the Group	**-**	**141**	**84**	**-**	**11**	**236**
Disposals[(1)]	**-**	**(28)**	**(47)**	**-**	**-**	**(75)**
Balance at December 31, 2007	**1,799**	**1,360**	**312**	**220**	**61**	**3,752**
Amortisation and losses from impairment						
Balance at January 1, 2006	-	648	181	-	22	851
Amortisation for the year	-	200	45	-	3	248
Loss from impairment	6	-	-	-	-	6
Deductions (1)	-	(74)	-	-	-	(74)
Balance at December 31, 2006	6	774	226	-	25	1,031
Balance at January 1, 2007	6	774	226	-	25	1,031
Amortisation for the year	**-**	**203**	**59**	**-**	**8**	**270**
Disposals[(1)]	**-**	**(28)**	**(47)**	**-**	**-**	**(75)**
Balance at December 31, 2007	**6**	**949**	**238**	**-**	**33**	**1,226**
Carrying value						
At January 1, 2006	1,793	526	45	220	28	2,612
At December 31, 2006	1,787	473	49	220	25	2,554
At December 31, 2007	**1,793**	**411**	**74**	**220**	**28**	**2,526**

* Less than NIS 500,000.

[(1)] Fully depreciated assets.

NOTE 10 – INTANGIBLE ASSETS (CONTD.)

Total value of goodwill allocated to each unit is as follows:

	2007	2006
	NIS millions	NIS millions
Pelephone Communications Ltd.[1]	**1,027**	1,027
D.B.S. Satellite Services (1998) Ltd.[2]	**760**	760
Others	**6**	-*
	1,793	1,787

* Less than NIS 500,000.

(1) The value of the holding in Pelephone was calculated by the Discount Cash Flow (DCF) method, and was based on the following assumptions:
A detailed projected was prepared for 5-year profit, which is a reasonable assessment range for which a detailed cash flow can be prepared.

- The cash flow forecast, based on the Pelephone's strategic plan to set up a third generation network (3.75) in HSPA/UMTS technology which is scheduled to start operation at the beginning of 2009. The new network will mean that Pelephone will operate in GSM technology, which will help it to achieve a higher market positioning, broaden the range of handsets it sells, and lead to overall improvement in its customer mix and ARPU. In addition, it will increase the company's revenue from roaming services. On the expense side, it will increase fees for transmission, frequencies and engineering, as well as marketing expenses for penetration of the new handsets.
- The income forecast was constructed on the basis of a forecast for the number of subscribers and average revenue per user (ARPU) according to the structure of revenues from departments plus revenues from sales of handsets. The subscriber forecast is based on a cellular company market model, taking into account market saturation, population growth, and assuming an increase of 1% in Pelephone's market share in the forecast periods.
- The assumptions for call time and call prices lead to erosion of approximately 1.5% in ARPU in 2008, and growth thereafter as a result of the effects of the strategic plan, at a cumulative rate of approximately 4% from 2007.
- The operating, sales and marketing expenses were adjusted for the company's volume of operations, with adjustment for operation of the HSPA network. Tax was deducted from the profit at the statutory tax rate.
- Investments were assessed according to Pelephone's investment plan, which consists mainly of investment of approximately one billion shekels in an HSPA network over four years, mainly in 2008, investment in IT and other ongoing and projected investments, as well as investment in subscriber acquisition.
- The capitalisation rate taken, 9.75% (nominal), was calculated by the WACC model and based on a capital price of 11.9% and a debt price of approximately 6.6%.
- Beyond the fifth year, growth of approximately 1.25% was assumed, taking into account that in the years of the forecast, Pelephone has not exhausted the advantages from transition to the HSPA network, population growth, the stabilization of the market among the cellular companies, and the competition possible future and alternatives.

The value obtained from these assumptions is highly sensitive to the following:

- An increase of one half of one percent in the capitalisation rate reduces the value by approximately 6%.
- A decrease of one percent in ARPU in the first year, decreases the value by 4%.

(2) The value of the holdings of DBS was calculated by the discounted cash flow method (DCF), and was based on the following data:

- A detailed projected cash flow was prepared for 10 years. Beyond the tenth year, growth of approximately 1.75% was assumed, taking into account the growth in population, the balance between DBS and the cable companies which merged into one company (HOT), as well as competition and possible future alternatives.

NOTE 10 – INTANGIBLE ASSETS (CONTD.)

(2) (contd.).

- The income forecast was prepared on the basis of projected number of subscribers and average revenue per user (ARPU) which provides the revenue from the services. The subscriber forecast is based on the business plan of DBS for the coming year and on continued growth based on the growth forecasts for households in Israel, the customer churn rate based on past experience, global trends, and a forecast of the stabilization of competition and lower churn rates, where it was assumed that the market share of DBS would increase over the years at the expense of HOT, to about 39% (compared with 37% today).
- The ARPU forecast is based on a price rise derived, *inter alia*, from DBS's strategy of selling YesMax sets and HDTV converters (which have a high ARPU) and added value added services, while taking into consideration competition and the weight of the expense in the total household expense.
- Operating, selling and marketing expenses were adjusted to the projected volume of activity, assuming content expenses (the main expense) declining gradually to approximately 30% of income (excluding internet).
- DBS has considerable losses for tax purposes. Accordingly, tax was not taken in the forecast period. After the forecast period, tax was taken at 25%, in respect of the part of the profit exceeding the cumulative loss at that date.
- Investments are mainly in installations, and in decoders which are a function of new subscribers, gross, and the accepted level of decoder replacement, based on past data. In addition, engineering investments for preserving what is and developing new areas.
- The capitalisation rate taken, 13.4%, took into account DBS's dependence on external financing, limitations and dependence on changes in regulation, and the equity structure of DBS.
- The calculated value was attributed initially to the new shareholder loans (which were provided after July 2002) of about NIS 1.125 billion, since under the agreement they will be paid before the old loans. The Company's part in the loans is approximately 85%. The balance was attributed to repayment of the shareholder loans, in which the Company's part is approximately 51%.

The value calculated with the above assumptions is highly sensitive to the following:

- An increase of one half of one percent in the capitalisation rate taken reduces the value by 7%.
- A decrease of one percent in the ARPU in the first year reduces the value by 3%.

The aforementioned valuations were made by an external appraiser. As a result of these value assessments, the Group was not required to make deductions for impairment of these goodwill balances.

NOTE 11 – DEFERRED AND OTHER EXPENSES

	2007	2006
	NIS millions	NIS millions
Land lease rights[(1)]	**185**	221
Long-term prepaid expenses in respect of use of capacities[(2)]	**177**	147
Long-term prepaid expenses in respect of lease agreement	**5**	6
	367	374

(1) Most of the real estate assets used by the Company were transferred to it by the State of Israel pursuant to and at the consideration stated in the asset transfer agreement signed between the Company and the State on January 31, 1984. Some of these assetswere leased for 49 years, with an option to extend for another 49 years, and some 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.

(2) See Note 3I

NOTE 12 – ASSOCIATES ACCOUNTED BY THE EQUITY METHOD

A. Below are condensed financial data regarding a principal associate accounted by the equity method, without adjustment for ownership percentage held by the Group.

	Rate of ownership	Current assets	Non-current assets	Total assets	Current liabilities	Non-current liabilities	Total liabilities	Income	Profit/loss
		NIS millions							
2007									
Walla! Communications Ltd.	34.41%	**134**	**22**	**156**	**55**	**3**	**58**	**99**	**15**
2006									
Walla! Communications Ltd.	44.04%	67	25	92	27	4	31	101	25

NOTE 12 – ASSOCIATES ACCOUNTED BY THE EQUITY METHOD (CONTD.)

B. The investment in an associate company comprises the investment of a consolidated subsidiary in Walla! Communications ("Walla") (an associate), an Israeli company whose shares are listed on the stock exchange in Tel Aviv, which provides internet services and operates internet portals, in Bezecom Ltd. and B-Zone partnership.

Composition of the investment

	December 31 2007	December 31 2006
	NIS millions	NIS millions
Cost of shares(1)	**80**	80
Exercisable option warrants	**-**	-*
Share in equity reserve in respect of financial assets classified as available for sale	**1**	1
Share in accumulated losses, net	**(24)**	(29)
	57	52
Index-linked interest-free loans(2)	**1**	1
	58	53
Reductions for impairment(1)	**(21)**	(21)
	37	32

* Less than NIS 500,000.

(1) The balance at December 31, 2007 and 2006 includes goodwill, the undepreciated cost of which at those dates amounts to NIS 46 million and NIS 46 million, respectively, and the depreciated cost at the same dates amounts to NIS 5 million and NIS 7 million respectively.

(2) During 2007 and 2006, Bezeq International exercised, as did others, option warrants of Walla (series 3). In all, Bezeq International exercised 508,879 and 2,564,764 option warrants (series 3) in 2007 and 2006 respectively, in consideration of NIS 916,000 and NIS 4.617 million respectively, which were offset against the balance of the shareholder loans which Bezeq International provided to Walla. Following the exercise of the options warrants, Bezeq International recognised a surplus cost of NIS 80,000 and NIS 2.313 million in 2007 and 2006, respectively. In accordance with the provisions of IFRS 3, the cost of the purchase was attributed to the fair value of intangible assets, based on the Purchase Price Allocation (PPA) prepared by an external appraiser.
At December 31, 2007, Bezeq International holds 34.41% of the rights in Walla (at full dilution – 33.66%). See also D below.

(3) The market value of Bezeq International's holding in Walla shares at December 31, 2007 is NIS 83.3 million (2006 – NIS 122.6 million in shares and NIS 3.2 million in options).

C. Movement in investments is as follows:

	2007	2006
	NIS millions	NIS millions
Balance at the beginning of the year	**32**	20
Movement during the year:		
Investment in shares	**1**	5
Group's equity in profits	**5**	12
Loans and capital notes	**(1)**	(5)
Balance at the end of the year	**37**	32

NOTE 12 – ASSOCIATES ACCOUNTED BY THE EQUITY METHOD (CONTD.)

D. Stock options plan for Walla employees

On January 15, 2008, Walla published an immediate report on a resolution of its board of directors to grant options to the employees of Walla in a remuneration plan. The remuneration plan is expected to consist of approximately 1.8 million options, comprising 3.71% of the equity of Wall at full dilution, convertible to approximately 1.8 million ordinary shares of Walla. In addition, the board of directors of Walla is entitled to cancel 0.4 million options granted to the CEO of Walla in the past, and to grant them anew in accordance with the new plan.
Implementation of the remuneration plan as described above is expected to reduce the Group's holding in Walla to 32.41% at full dilution.

NOTE 13 – LOANS AND BORROWINGS

This Note provides information about the contractual terms of the interest-bearing loans and borrowings. For more information about the exposure of the Group to interest rate and foreign currency risks, see Note 30.

A. Composition

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
Current liabilities to banks		
Short-term borrowings	**81**	118
Current maturities of debentures	**841**	1,993
Current maturities of bank loans	**991**	1,526
	1,913	3,637
Non-current liabilities to banks and others		
Debentures	**4,420**	3,170
Bank loans	**307**	481
Loans from institutional entities	**136**	169
	4,863	3,820
	6,776	7,457
Loans provided by the minority in a consolidated company	**375**	564

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

B. Terms and debt repayment table

	Currency	Nominal interest rate %	Redemption year	December 31, 2007 Par value	December 31, 2007 Carrying value	December 31, 2006 Par value	December 31, 2006 Carrying value
				NIS millions			
Short-term borrowings	Shekel	Prime + (1.1-1.5)	2008	**81**	**81**	118	118
Loans from banks and others:							
Index-linked*	Shekel	3.9-11.0	2008-2015	**532**	**588**	1,486	1,528
Unlinked[(1)]	Shekel	PRIME + (1.15-1.112)	2008-2013	**846**	**846**	648	648
					1,515		2,294
Debentures issued to the public:							
Index-linked series 4 and 5[(3)]	Shekel	4.8-5.3	2008-2016	**2,707**	**2,959**	1,637	1,704
In foreign currency[(4)]	euro	6.5	2007	**-**	**-**	1,630	1,629
					2,959		3,333
Debentures issued to financial and other institutions:							
Index-linked**	Shekel	4.40-7.9	2008-2017	**2,160**	**2,271**	1,726	1,799
Linked to the euro	Shekel	LIBOR + 0.8	2008	**22**	**31**	22	31
					2,302		1,830
Total interest-bearing liabilities					**6,776**		7,457
Loans provided by the minority in a subsidiary (see E below)	Shekel (Index-linked)	0-11	2017	**1,012**	**375**	1,012	564

* For long-term loans of DBS from institutional bodies, the balance of which at December 31, 2007 is approximately NIS 136 million, see B(2) below.
** For an issue of DBS in July 2007, see B(5) below, and for debentures of Pelephone, see B(6) below.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

B. Terms and debt repayment table (contd.)

(1) DBS's bank loans of approximately NIS 846 million are repaid according to a repayment schedule over a period of 8 years commencing December 31, 2005. Under the loan agreements, DBS can change the loan tracks every year or two years, commencing December 31, 2005.
The next date for selecting a loan track is December 31, 2008.

(2) a. In March and April 2005, DBS signed agreements with three institutional entities, whereby those entities would provide loans to DBS in a total amount of NIS 50 million.

The three institutional entities were granted an option to provide additional loans in the same equal amount provided by them, provided that the amounts of the loans are required by the business plan of DBS. During 2005, the three institutional entities exercised the above options, and provided DBS with additional loans amounting to NIS 50 million.

These loans are Index-linked and bear 11% interest. The loans are repayable together with the interest and linkage differentials on December 31, 2013, but may be repaid earlier, subject to repayment of part of the bank loans under the terms laid down in the loan agreements.

The Company undertook, in connection with the aforementioned loans, that if by December 31, 2013, the loans were not repaid (all or part thereof) or upon fulfilment of certain other conditions, the lenders could demand that it repay the lower of the balance of the loans (principal, interest and linkage) and an amount computed according to a formula which was determined, which takes into account the value of DBS at that date. In view of the Company's undertaking, on June 22, 2005 the Company received a letter from the then Director General of the Ministry of Communications, giving notice of the decision of the Ministry to call in a guarantee in the amount of NIS 10 million out of the bank guarantee the Company had provided in accordance with the provisions of its general license. According to the Director General's notice, the decision to call in the guarantee was made in view of the fact that the Company had made a commitment to the institutional entities in a manner which contravenes the directive of the Minister of Communications. The Company's position is that there are no legal or other grounds for forfeiture of the guarantee. An appeal against the decision was submitted to the then Minister of Communications, due to which the forfeiture was stayed until receipt of the ruling of the Supreme Court In September 2007 on the petitions filed by the Company. In February 2008, a hearing of the Company's appeal was held before the Minister of Communications, and the Company believes that the guarantee will be forfeited. The financial statements include a provision which the Company's Management deems appropriate. See also Note 33(3).

(b) In December 2006, DBS signed an agreement with another institutional entity for receipt of a loan of NIS 50 million. The aforementioned loan is linked to the Index and bears interest at an annual rate of 8%. DBS was granted an option for an additional loan in the same amount. DBS exercised the option in June 2007. Following the issue of the debentures (described in section (5) below), the loan agreement was amended and the parties agreed that DBS would repay the principal – NIS 100 million, upon receipt of the funds raised in the issue, since the institutional investor purchased debentures in the framework of the issue. The loan was repaid during the reporting period as described above.

(c) The balance of the loans from institutional entities at December 31, 2007 includes accrued interest of NIS 31 million (2006 – NIS 17 million).

(3) The balance of the par value of the debentures is NIS 3,586,967,000, of which NIS 2,706,867,000 par value was issued to the public.

a. The balance of the par value of the debentures (series 4) is 1,200,000,000 of NIS 1 par value each, repayable in 4 equal annual instalments in each of the years 2008 – 2011. The interest rate for these debentures is 4.8% p.a.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

B. Terms and debt repayment table (contd.)

(3) (contd.)

b. The balance of the par value of the 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, and the balance of 880,100,000 to Bezeq Zahav Holdings Ltd. (wholly controlled by the Company). The debentures are payable in 6 equal annual instalments in each of the years 2011-2016. The interest rate for these debentures is 5.3% p.a.

The debentures were registered on the stock exchange and trading in a portion of them will be subject to the lock-up limitations prescribed in the Securities Law

(4) The balance of the par value of the debentures held by the public on December 31, 2006 was 293,000,000 euro. These debentures were repaid in August 2007.

(5) On July 31, 2007, in a private placement. DBS issued approximately NIS 620 million par value of debentures (series A) to institutional investors, to be registered in a continuous institutional system on the Tel Aviv stock exchange. For the issuance, the debentures were rated by Maalot Securities Rating Co. Ltd. ("the Rating Company") at BBB-/stable. The net proceeds from the issuance amounted to approximately NIS 614 million.

The debentures are repayable in 8 annual payments of principal and interest of July 5th of each of the years 2010 – 2017, where the payments of the principal in each of the years 2010 – 2013 will be at 8% of the par value of the debentures and the payments of the principal in each of the years 2014 – 2017 will be at 17% of the par value of the debentures. The debentures are linked to the Index commencing June 2007, and bear annual linked interest at 7.9% (subject to various possible adjustments pursuant to the terms of the debentures), which will be paid in half-yearly instalments in January and July of each of the years 2009 – 2017.

DBS did not undertake to list the debentures for trading on the stock exchange; however, if they are listed, the annual interest paid on them from that date will be reduced to 7.4%. Conversely, if the debentures are not listed by July 31, 2008, the annual interest rate paid on them will increase to 8.4% as long as they are not listed (and in the event of later listing, the interest rate from that date will be reduced to 7.4% as aforesaid).
If the rating of the debentures is lowered by two rating levels without the debentures having been listed, then the annual interest rate will be increased to 8% until the original rating is restored or until the debentures are listed (in which case, the above-mentioned lowering of the interest rate will apply additionally). Furthermore, if DBS does not comply with the terms set out in the financing agreement between it and the banks, and as a condition for the banks waiving such violation, DBS undertook to pay the banks, in respect of the bank credit, an additional margin on the bank interest, and if at that time the debentures are not listed for trading, then as long as the banks are paid such an additional margin and the debentures are not listed, DBS will pay the debenture- holders additional annual interest at the same rate.

(6) Pelephone had four series of debentures issued in a private placement to institutional investors. The debentures, which were issued at par value, are linked to the Index, bear annual interest of 4.4% - 5.2%, and are repayable in 20 equal semi-annual payments. The interest is paid on the unpaid balance of the principal. The balance of the debentures at December 31, 2007, is approximately NIS 895 million.

C. Charges and collateral

(1) The private debentures of the Company, whose carrying value at December 31, 2007 is approximately NIS 750 million, are secured by a symbolic charge. In addition, the Company created a negative pledge in favour of the holders of those debentures.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

C. Charges and collateral (contd.)

(1) (contd.)

The lenders have a right to call for immediate payment of the debentures in cases where the Company does not pay the debentures or violates their terms, if a significant attachment is imposed on its assets (which is not lifted within 60 days), if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to run its business, or if the holder of another charge realises the charge it has on the assets of the Company.

In addition, some of the lenders, from whom the balance of the debentures at December 31, 2007 is approximately NIS 159 million, may call for immediate payment of the debentures if the State's holdings in the share capital of the Company falls below 26% (a condition that was met commencing October 11, 2005). For this reason, the balance in the financial statements is stated as a short-term liability.

The Company's position is that at the reporting date, it is in compliance with all the aforementioned terms, except for the holdings of the State.

(2) a. The bank loans and debentures ("credit providers") of Pelephone, the carrying amount of which at December 31, 2007 is NIS 1.347 million, are secured by an irrevocable liability of Pelephone in favour of the credit providers, not to encumber its assets without their consent, i.e. a negative pledge.

The liability includes, *inter alia*:

(1) A declaration that Pelephone will not encumber its assets (as may be from time to time), in whole or in part, in any manner including by means of a floating lien or a fixed lien of any type or rank, in favour of any third party, without the prior written consent of the credit providers.

(2) Compliance with the following financial stipulations:

a. An undertaking that Pelephone's debt will not exceed three times its shareholders' equity and an undertaking that as long as that ratio exceeds 2.5, dividends will not be distributed and management fees will not be paid to the shareholders.

b. Pelephone undertook that the amount of its debts will not exceed NIS 3.8 billion (linked to the known Index in January 2002).

c. An undertaking towards a certain bank that its total debt to it will not exceed 40% of its total debts to all the financial entities.

At the date of the financial statements, Pelephone is in compliance with its undertakings and the financial stipulations with which it undertook to comply for the banks. Non-compliance with these undertakings would cause the loans received by Pelephone from the banks to be immediately repayable.

b. Under its general license for cellular services, Pelephone is not permitted to sell, lease or pledge any of its assets used for performance of the license, without the consent of the Minister of Communications, except –

(1) charge of one of the license assets in favour of a bank operating lawfully in Israel, for receipt of bank credit, provided that it submitted notice to the Ministry of Communications concerning the charge it intends to register, noting that the charge agreement includes a clause ensuring that in any case, exercise of the rights by the bank will not harm in any way the provision of the services pursuant to the license;

(2) the sale of items of equipment when implementing an upgrade proceeding, including sale of equipment by the trade-in method.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

C. Charges and collateral (contd.)

(3) During 2005, the banks completed the transfer of the entire credit line to which DBS was entitled under the financing agreements.

The terms of long-term loans which DBS received from banks, the balance of which at December 31, 2007, is NIS 974 million (which includes short-term borrowings of approximately NIS 81 million and shekel loans at variable interest of approximately NIS 846 million), impose restrictions with regard to the lien or sale of certain assets,, a restriction on receipt of credit from other banks (without the prior approval of the lending bank), a restriction on distribution of a dividend, a restriction with regard to repayment of shareholder loans, and restrictions on transactions with interested parties, a restriction on changes in the holdings of shareholders, restrictions relating to providing DBS with various licenses granted to it, restrictions relating to the purchase of securities by DBS and the establishment of a subsidiary, restrictions relating to the issuance of shares or other securities of DBS.

In addition, the terms of the loans impose various restrictions, including a demand to comply with the following financial covenants:

a. Minimum total income.
b. Minimum operating surplus (as defined in the financing agreement).
c. Minimum operating surplus less investment in decoders (as defined in the financing agreement).
d. Maximum churn rate.
e. Total financing needs (as defined in the financing agreement).
f. Maximum supplier credit.
g. Minimum cover of bank debt and debt balances (as defined in the financing agreement).

The values for compliance with the financial covenants vary, and are measured each quarter. Non-compliance with the financial covenants grants the banks a right to demand early repayment of the loans DBS received.

On July 22, 2007, DBS and the banks signed an eighth addendum ("the Addendum") to the financing agreement, which determines the following matters:

a. The terms laid down in the financing agreement were updated.
b. A reserve was created from the proceeds of an issuance of debentures by DBS in July 2007 as mentioned in section B(5) above. Under the Addendum, the issue of the debentures will be used by DBS for partial repayment of the bank credit, for repayment of the loan DBS took from an institutional entity in 2006 (including a bridge loan provided by that entity to DBS in June 2007), in the amount of NIS 100 million, and for DBS's current operations.

At December 31, 2007, DBS is not in compliance with the financial criteria set for it. Subsequent to the balance sheet date, DBS received relief in connection with those criteria at December 31, 2007, whereby at the date of approval of the financial statements, DBS is in compliance with the terns laid down in the financing agreement.

Since DBS prepares its financial statements in accordance with IFRSs, which require review of DBS's compliance with the terms at the date of the financial statements, the loans at December 31, 2007 are classified under short-term liabilities.

DBS requested the banks that they update the stipulations for 2008 in order that they correspond to DBS's budget. On March 6, 2008, DBS received the banks' consent to amend the aforementioned stipulations.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

C. Charges and collateral (contd.)

(3) (contd.)

According to the assessments of DBS's management, the financing resources available to it will be sufficient for its operational requirements for the coming year, based on the cash flow projections approved by DBS's board of directors and if additional resources are needed for those requirements in the coming year, DBS will adapt its activities so that additional resources will not be required beyond those at its disposal.

To secure these liabilities and guarantees, DBS registered a charge on all its assets, including shareholders' equity and goodwill.

(4) The debentures issued by DBS as described above in Section B(5), are secured by a senior floating charge on all the assets of DBS (except for those excluded pursuant to the Communications Law) in an unlimited amount, as well as a senior fixed charge of unlimited amount on the rights and assets of DBS which it encumbered in favour of banks (except for those excluded pursuant to the Communications Law). These securities are first rank and *pari passu* to the floating charges and fixed charge created by DBS in favour of the banks to secure the bank credit.

In October 2007, Maalot announced that the debentures had been placed on the Watch list due to the disruptions in DBS's broadcasts, since, it said, they led to a higher level of expenses than expected, to a deviation from the business plan of DBS and to the filing of a number of legal claims against it. In February 2008, Maalot announced that the debentures had been removed from the Watch list and affirmed the BBB-/stable rating, *inter alia* since DBS had succeeded in preserving its subscriber base and in meeting the subscriber target set prior to the disruption event.

On October 21, 2007, DBS received a letter from the trustee of the debentures, noting that following the disruptions in broadcasts and the subsequent publicity about them, including about the decreasing number of DBS's subscribers and the compensation that DBS granted its subscribers, and requesting various documents and approvals from DBS in order to ascertain whether those events and their long-term implications could have an adverse effect of DBS's undertakings to the debenture-holders. Following the enquiry from the trustee, a meeting and discussion on the matter was held between the trustee and DBS and as a result of the aforementioned Maalot notification that DBS had been taken off the Watch list the trustee notified DBS of the return to the regular reporting format required by the deed of trust.

(5) For the matter of a charge provided by the shareholders of DBS, see Note 19H below.

D. Debenture issue expenses

The expenses for issuing the debentures amounted to approximately NIS 11 million for 2007 (2006 – NIS 22 million), and are presented after deduction of accumulated amortisation of approximately NIS 4 million (2006 – NIS 14 million).

E. Loans provided by the minority in a consolidated company

Loans provided by the shareholders of DBS were included in the DBS financial statements according to their fair value when received. The fair value of the loans was determined according to the present value of the cash flows anticipated in respect of loan repayment, taking into account the dates on which the shareholders would first be able to demand repayment of the loans (in accordance with the restrictions to which the shareholders consented in agreements with the banks and financial institutions), and the interest rates applicable to loans carrying a similar risk on the dates of receipt of the loans. The interest rate taken into account as aforesaid, which constitutes the effective interest rate in respect of the loans, is 12%.

NOTE 13 – LOANS AND BORROWINGS (CONTD.)

E. Loans provided by the minority in a consolidated company (contd.)

When a change occurs in the terms of the loans which gives rise to a difference of more than 10% in the discounted cash flows, the difference between the cash flows expected before the change when they are discounted at the interest rate on the date of provision of the loan, and their discounted value at the interest rate on the date of the change, is recognized in finance income. The difference between the present value of the new cash flows when discounted at the interest rate on the date of the change, and the old cash flows when discounted at the interest rate on the date of the change, is charged to a capital fund under equity.

During 2007, as part of the rating process of the debentures with the Rating Company, it was agreed to postpone the dates on which the shareholders would first be able to demand repayment of the loans.

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 capitalisation of the interest-free shareholder loans is 15.63%, and the interest rate for capitalisation of the shareholder loans bearing 5.5% interest is 15.58%. In accordance with these rates, the difference between the cash flows anticipated before the change when discounted at the interest rate on the date of providing the loan 12% and their discounted value at the interest rate on the date of the change 15.63% or 15.58%, as the case may be, which amounted to approximately NIS 213 million, was charged to finance income in the financial statements of DBS, and approximately NIA 96 million in the consolidated statement. Income of NIS 96 million in the consolidated statement was attributed to minority rights, and did not impact the share of the equity holders of the Company.

The difference between the present value of the anticipated cash flows prior to the new repayment dates and the present value of the cash flows that were anticipated according to the repayment dates before the change when discounted at the interest rate on the date of the change 15.63% or 15.58%, which amounted to NIS 348 million, was charged to a capital reserve in the financial statements of DBS, of which approximately NIS 160 million was recognised as the minority interest in the consolidated statement. These differences, which relate to loans provided by the minority shareholders in DBS, are expected to impact the finance expense in the consolidated statement in the future, and conversely, to increase the loss that will be attributed to the minority in DBS.

NOTE 14 – TRADE AND OTHER PAYABLES, INCLUDING DERIVATIVES

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
Trade payables		
Outstanding debts	**1,407**	1,221
Notes payable	**56**	84
Trade payables who are related parties and interested parties	**70**	88
Total trade payables	**1,533**	1,393
Other payables, including derivatives		
Government of Israel in respect of royalties	**54**	65
Liabilities to employees and other liabilities for salary and wages	**271**	298
Institutions	**148**	105
Liabilities to related parties and interested parties	**48**	49
Accrued interest	**120**	136
Derivatives	**12**	28
Payables and other credit balances	**92**	122
Total other payables, including derivatives	**745**	803
	2,278	2,196

Amounts payable denominated in a currency other than the functional currency include approximately NIS 313 million in respect of suppliers denominated in US dollars (2006 – NIS 381 million), and approximately NIS 8 million in respect of suppliers denominated in euro (2006 – NIS 20 million).

NOTE 15 – PROVISIONS

	Legal claims and other disputes	Employee claims	Dismantling and clearing of sites	Onerous contracts	Warranty and others	Total
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Balance at January 1, 2007	173	105	44	8	11	341
Provisions created during the period	**50**	**60**	**4**	**12**	**4**	**130**
Provisions used during the period	**(19)**	**-**	**(2)**	**(1)**	**(2)**	**(24)**
Provisions cancelled during the period	**(2)**	**-**	**-**	**-**	**-**	**(2)**
Effect of the elapse of time in respect of capitalisation	**4**	**-**	**-***	**-***	**-**	**4**
Balance at December 31, 2007	**206**	**165**	**46**	**19**	**13**	**449**
Current	**206**	**165**	**-**	**8**	**13**	**392**
Non-current	**-**	**-**	**46**	**11**	**-**	**57**

* Less than NIS 500,000.

NOTE 15 – PROVISIONS (CONTD.)

Legal claims
For salary claims filed against the Group and legal claims and other disputes, see also Note 17.

Dismantling and clearing of sites
The provision is in respect of an obligation of some of the Group's companies to clear sites they lease.

Onerous contracts
This item stems mainly from an agreement of a consolidated company granting it usage rights in transmission equipment (an old generation of sea-bed cables), for periods ending between 2016 and 2024. Under these agreements, the subsidiary is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of the cables. The management of the consolidated company believes that the unavoidable costs of compliance with these agreements exceed the economic benefits expected to accrue from use the cables. This assessment, together with the management's decision not to operate the sea-bed cables, was the rationale for making a provision in the financial statements. The balance of the provision reflects the discounted value of all the unavoidable costs which the subsidiary must pay to the owner of the cables until the end of the term of the agreements.

NOTE 16 – EMPLOYEE BENEFITS

A. Composition

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
Present value of unfunded obligations	**287**	245
Present value of funded obligations	**161**	196
Total present value of liabilities	**448**	441
Fair value of plan assets	**(104)**	(130)
	344	311
Cost of past service – benefit not yet vested	**(49)**	(73)
Recognised liability in respect of a defined benefit plan	**295**	238
Liability for vacation	**84**	96
Liability for sick leave	**70**	65
Liability for voluntary early retirement	**517***	880
Total employee benefits	**966**	1,279
Stated in the balance sheet as follows:		
Short-term	**705**	906
Long-term	**261**	373
	966	1,279

* Less advance payments transferred to an insurance company (Harel).

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

A. Composition (contd.)

	For the year ended December 31	
	2007	2006
	NIS millions	NIS millions
Movement in a liability in respect of a defined benefit plan		
Liability in respect of a defined benefit plan at January 1	**441**	314
Benefits paid according to the plans	**(81)**	(21)
Costs of current service and interest (see below)	**128**	46
Cost of past service – benefit not yet vested	**-**	73
Cost of past service – benefit vested	**-**	32
Cutbacks	**(21)**	-
Exchange rate differences in respect of a foreign currency plan	**(4)**	-
Actuarial gains charged to equity (see below)	**(15)**	(3)
Liability in respect of defined benefit plans at December 31	**448**	441
Movement in the plan's assets		
Fair value of the plan's assets at January 1	**130**	114
Amounts deposited in the plan	**32**	21
Benefits paid	**(62)**	(9)
Expected return on the plan's assets	**5**	4
Actuarial gains (losses) charged to equity (see below)	**(1)**	-*
Fair value of the plan's assets at December 31	**104**	130
Movement in the cost of past service – unvested benefit		
Cost of past service – unvested benefit January 1	**73**	-
Cutbacks	**(21)**	-
Amortisation of cost of past service	**(3)**	-
Cost of past service – unvested benefit	**-**	73
Cost of past service – unvested benefit at December 31	**49**	73
Expense charged to profit and loss		
Costs of current service	**107**	34
Interest on the obligation	**21**	12
Return expected on the plan's assets	**(5)**	(4)
Exchange rate differences in respect of a foreign currency plan	**(4)**	-
Amortisation of cost of past service	**3**	-
Cost of past service – benefit vested	**-**	32
	122	74
The expense was included in the following items in the income statement		
Salary expenses	**68**	66
Other operating expenses	**42**	-
Financing expenses	**12**	8
	122	74
Actual return on the plan's assets	**6**	3
Actuarial gains and losses charged directly to equity		
Amount accrued at January 1	**12**	15
Amounts recognised during the period	**(14)**	(3)
Amount accrued at December 31	**(2)**	12

* Less than NIS 500,000.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

B. Actuarial assumptions

The principle actuarial assumptions at the date of the report:

(1) Mortality rates are based on the rates published in Insurance Circular 3-1-2007 of the Ministry of Finance, except for early retirement, which was calculated according to the agreement with Harel, and including future improvements in the mortality rate.

(2) Turnover rates were determined on the basis of the past experience of the Company and the subsidiaries, distinguishing between employees entitled to supplementary compensation and those who are not, depending on the number of years of employment in addition to the above distinction made. In the Company – the turnover rate is determined, additionally, with a distinction made between permanent employees (between 3.5% in the first year to 0.5% over 10 years), personal contract employees (5.5% per year), senior employees (20% per year), and temporary employees (between 34% in the first year and 25% over 7 years).
Bezeq International – The turnover rate includes a distinction made between headquarters' employees with compensation (between 2.2% for the first year up to 4% over 11 years), headquarters' employees without compensation (between 17.6% for the first year to 2% from the seventh year onwards), non-headquarters' employees with compensation (3.3% in the first year to 4% over 11 years), headquarters employees without compensation (48.1% in the first year to 3% over 6 years). Pelephone – The turnover rate includes a distinction made between senior employees with compensation (8% per year), senior employees without compensation (12% for the first year and 2.5% over 11 years), non-senior employees with compensation (5% for the first year and 25% from the second year), and non-senior employees without compensation (45% for the first year and 7% from the third year). DBS – The turnover rate includes a distinction between employees with compensation (between 20.66% in the first year to 2% in the fifth year and over) and employees without compensation (between 27% in the first year and 2% in the fifth year and over).

(3) The discounted rate is based on yield on government bonds at a fixed interest rate which have a lifetime equal to that of the gross liability.

	December 31, 2007	December 31, 2006
	Discounted rate	Discounted rate
Compensation	**3.4%**	3.7%
Sick leave	**3.6%**	3.6%
Vacation	**3.4%**	3.6%
Retirement benefit – holiday gift*	**5.3%**	5.2%
Retirement benefit – clubs and activities	**3.6%**	3.6%
Early notice to senior employees	**3.3%**	3.6%

* At a discount rate based on American corporate debentures.

(4) Assumptions regarding salary increments were made on the basis of the Company's experience and Management's assessments, distinguishing between groups of employees as explained in sub-section 2 above over the period of their service to retirement.
The Company – For permanent employees, the average salary increment is 6% for young employees, with a linear decrease to 1.75% per year up to age 60. For temporary workers, salary increments average 0.45% at every age. For senior employees, an average increment of 6% per year.
Bezeq International – For headquarters' employees, salary costs of 7% per year to age 34 and from that age, a linear decrease of 1% until stabilisation at an increment of 1% per year from age 40. For workers who are not headquarters' employees, the rate of the increment is 1%.
Pelephone – For senior employees at age 21, salary costs of 4% increases linearly to 14% at age 28, and from that age onwards, decreases linearly to 2.5% at age 39. For non-senior employees from age 21 to age 28 a salary increment of 16%, and from that age a linear decrease to 2.5% at age 39.
DBS – For all employees, the salary increment rate is 5% per year throughout the period of service.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

B. Actuarial assumptions (contd.)

(5) The forecasted growth rate of the assets accumulated in all the companies in the Group, except those Company employees who do not have senior status, is 3% per year – a rate reflecting an expected return value of 4% and a deduction of 1% management fees, while in the Company, for employees who are not senior, the growth rate in accumulated assets is only 2%. This rate reflects the fact that most of the funds are in old pension funds in which the yield rate is fixed.

(6) An obligation in respect of 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 5, 2006 (see section H) and in accordance with the terms with Harel (see section G). The obligation is influenced by changes in the interest rate of the debentures up to the date of purchase of the policies and their payment to Harel.

C.

	December 31, 2007	December 31, 2006	December 31, 2005
	NIS millions	NIS millions	NIS millions
Present value of the defined benefit plan obligation	**448**	441	314
Fair value of plan assets	**(104)**	(130)	(114)
Deficit in the plan	**344**	311	200
Adjustments for liabilities arising from past experience	**15**	4	
Adjustments for assets arising from past experience	**1**	(4)	

In 2008, the Group expects to pay NIS 20.6 million as a contribution to a defined benefit plan.

D. Defined contribution plans

(1) The pension rights of Company employees in respect of the period of their employment in the civil service through January 31, 1985, are covered by a pension fund ("Makefet Fund"), which took upon itself the State's commitment following an agreement between the Government of Israel, the Company, and General Workers' Histadrut and the Fund.

(2) Liabilities for employee benefits at retirement age in respect of the period of their service in the Company and in the investee companies, are covered in full by regular payments to pensions funds and insurance companies.

(3) The severance obligation to those who leave their employment on terms entitling them to compensation, is covered, for the period from February 1, 1985. by regular contributions to aforementioned pension funds and insurance companies (in accordance with Section 14 of the Severance Pay Law). Severance pay in respect of the period of employment in the Civil Service through January 31, 1985, is actually paid by the Company, and the monies accumulated in the Makefet Fund in respect of that period is maintained in a fund that will be used for the employees' rights. In respect of a small number of the employees (employed under special contracts), the Company has an obligation to pay severance in excess of the amount accumulated in the compensation fund which is in the employees' name.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

E. Defined benefit plan

(1) The severance obligation included in the balance sheet represents the balance of the obligation not covered by contributions and/or insurance policies in accordance with the existing labour agreements, the Severance Pay Law, and the salary components which the managements of the companies believe entitle the employees to receipt of compensation. In respect of this part of the obligation, there is a reserve deposited in the Company's name in a recognised compensation fund. The reserves in compensation funds include accrued linkage differentials and interest accrued and deposited in compensation funds in banks and insurance companies. Withdrawal of the reserve monies is contingent upon fulfilment of detailed provisions in the Severance Pay Law.

(2) The collective agreement dated December 5, 2006 (see Section H(1) below), provides, among others, that employees who transferred from the civil service to the Company, who end their employment due to retirement after December 31, 2013, are entitled to a supplement to close the gap between the two Civil Service Law tracks and the regulations governing Makefet. As a result of this clause in the agreement, the benefit to these employees is enhanced. The Company includes in its financial statements the liability net of the cost of prior service not yet vested. This benefit will be spread on a straight line basis over a period of 18.75 years (the average period to vesting of the benefit).

(3) Through December 2005, liability in respect of early notice for senior employees was not included in the financial statements. In September 2006, the Company's Management decided that this benefit should be paid upon cessation of the employer employee relationship. Accordingly, the liability is included in the financial statements in accordance with the employment agreement and an actuarial calculation. The increase in the benefit in respect of this change is recorded as cost of prior service vested immediately, and is therefore recognised immediately in profit and loss.

(4) Company retirees receive, in addition to the pension payments, benefits which consist mainly of a holiday gift, financing of the maintenance of retiree clubs and social activities. The Company's liability in respect of these costs accumulates during the service period. The Company includes in its financial statements the expected costs in respect of the post-employment period, based on an actuarial calculation for existing retirees and for the serving employees entitled to this benefit according to retirement age. The actuarial assumptions include those noted in section B above, and another assumption relating to this section – that there is no real increase in the benefits in accordance with Company policy. (It is noted that in practice, the holiday gift benefit is linked to the dollar exchange rate.)

F. Other long-term employee benefits

Provision for sick leave
The financial statements include a provision in respect of redemption and utilisation of sick leave for all Group employees and redemption of sick leave only for employees eligible under the terms of the employment agreement and the collective agreement dated December 5, 2006. The provision was computed on the basis of an actuarial calculation. The actuarial assumptions include those noted in section B above, as well as assumptions in connection with this section based on the Company's experience according to positive accumulation of days by most of the employees and utilisation of days by the LIFO method.

Provision for vacation
The financial statements include a provision for redemption and utilisation of vacation on the basis of an actuarial calculation. The actuarial assumptions include those noted in section B above, as well as assumptions in connection with this section - positive accumulation of days by most of the employees, utilisation of days by the LIFO method, and statistical tests for the amount of utilisation and the amount of redemption.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

G. Benefits in respect of dismissal and early retirement

A number of collective agreements concerning early retirement were signed in recent years. Below are details of the relevant agreements:

In September 2000, the Company reached an agreement with the employees' representatives to extend the early retirement collective agreement from 1997 ("the Retirement Agreement"). Under the Retirement Agreement, commencing April 1, 2001 and through December 31, 2006 (with an option to extend the date of final retirement for certain employees through December 31, 2008), another 1,770 employees will take early retirement, of whom 300 employees are not transferred employees.

On April 17, 2005, a special collective agreement was signed between the Company and the employees' representatives and the Histadrut, enabling early retirement of employees through a substitute for Makefet Fund. On June 28, 2005, an agreement between the Company and Harel Insurance Co, Ltd. ("Harel") was completed and signed. The agreement regulates pension payments in respect of early retirement, as well as old age and survivor pension payment differences arising from legislative amendments to the Israel Economic Recovery Plan (Legislative amendments for attaining budget targets and the economic policy for the 2003 and 2004 financial years) Law, 5763-2003, for employees who retired commencing at the end of 2003 and until the beginning of 2004, and/or who will retire from the Company in accordance with the special collective agreement for retirement signed in September 2000, as amended on March 18, 2004 ("the Retirement Agreement").

Following execution of the agreement with Harel, the aforementioned special collective agreement between the Company, the employees' representatives and the Histadrut was revised and amended on the same date (June 28, 2005). On February 14, 2008, an amendment to the June 2005 agreement was signed by the Company and Harel, which contains the following main points:

(1) the June 2005 agreement will also apply to Company employees who retire from their employment in the Company by December 31, 2013 in the early pension track in accordance with the option granted to the Company in the special collective agreement of December 5, 2006, if and insofar as the Company chooses to exercise that option;

(2) reduction of the contribution paid by the Company to Harel in respect of each retiree who is insured in accordance with the June 2005 agreement, where a policy had not yet been issued by Harel in respect of him on the date of the signature of the amendment to the June 2005 agreement.

H. Other

(1) On December 5, 2006, the Board of Directors of the Company approved a new collective agreement between the Company and the employees' organisation and the New General Workers' Histadrut. The agreement regulates the labour relations in the Company following the transfer of control in the Company from the State of Israel, and delineates a new organisational structure for the Company. Below are the main points of the agreement:

a. All the agreements, arrangements and customs existing in the Company prior to execution of the agreement, including a mechanism for linking salaries to the public sector, will continue to apply only to the veteran permanent employees in the Company to whom the agreement applies, subject to changes inserted specifically in the present agreement. The hiring of existing and new temporary employees will be on the basis of monthly or hourly salary agreements based on a market salary model by occupation, with a high degree of managerial flexibility.

b. An organisational change was agreed upon, including on the basis, *inter alia*, of transition from a geographical structure to a functional structure, which will be implemented gradually over two years.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

H. Other (contd.)

(1) (contd.)

c. In 2006-2008, 975 permanent employees (325 in each of those years) will retire from the Company in early pension or increased compensation tracks. The quota of retirees includes the employees who were scheduled to retire in accordance with the previous early retirement agreements but have not yet done so. In addition, the Company may, at its discretion, terminate the service of another 1,225 permanent employees (245 permanent employees in one or more of the years 2009-2013). The terms of retirement that will be granted to retirees will be largely the same as the terms of retirement prevailing in the Company today.

d. On the subject of managerial flexibility and changes in existing agreements and arrangements, the Company may determine procedures and change them from time to time at its discretion (without derogating from the rights of employees under the collective agreements applicable to them). The Company has authority in all management matters, the organization, work arrangements, work processes, etc.

e. The employees' organization declared that it would agree to and support the distribution of a dividend of NIS 1.8 billion to the shareholders which does not comply with the earnings test, which the Company intends to distribute with the approval of the court. The Company undertook that within 45 days of the date of completing the aforementioned distribution, it would issue stock options to employees amounting to 3% of the Company's issued share capital (subject to increasing its registered capital and the approval of the authorised institutions of the Company), at an exercise price of 50% of the share price on the date of issue of the options. If issue of the options is not approved, the benefit will be awarded to the employees in cash. (See Note 26.)

f. In addition, the Company will pay the employees a special bonus for the period through December 31, 2006, in a total amount of NIS 44 million. Commencing in 2007, the bonus system which had been customary in the Company (as a State-controlled company) would be changed in the manner detailed in the agreement.

g. The term of the agreement is from the date of its execution through December 31, 2011. The Company has an option to extend it for two additional years, through December 31, 2013. The term of the retirement section in the agreement (see section C above), will in any case be through December 31, 2013.

An amendment to the new collective agreement is being discussed by the Company and the employees' representatives, mainly concerning the organisational structure being brought forward (with minor changes) and concerning earlier retirement ages and a change in the mix of retirees. The financial statements include a revised provision for retirement in accordance with the amendment being formulated.

NOTE 16 – EMPLOYEE BENEFITS (CONTD.)

H. Other (contd.)

(2) Under the collective agreements applicable to labour relations in the Company, and in accordance with agreements with the Makefet Fund ("the Fund"), an option is reserved for Company employees, who are Transferred Employees, to retire under one of two retirement tracks. The method of calculation of the cost of the early retirement of the Transferred Employees was laid down in the provisions in a number of agreements and documents drawn up between the Company and the Fund between 1990 and 1996, including a letter of understanding prepared and signed by them in 1996. The Company contends that the Fund violated the provisions of the agreements in general, and those in the letter of understanding in particular, in that when making the calculations of early retirement costs for Transferred Employees, the Fund determined those data on the basis of the assumption that those employees had chosen the track in which the cost of acquisition is higher, while disregarding the track which those employees had actually chosen. According to an actuarial opinion prepared for the Company, the difference between the payments collected by the Fund from the Company according to its calculation, and the rate of those costs if made as contended by the Company, based on the retirement track actually chosen by the employees, is a cumulative nominal amount of more than NIS 128 million, the restitution of which the Company is claiming in a claim it filed against the Fund. On November 20, 2003, the Company filed another claim against the Fund for additional amounts, in respect of other components, amounting to approximately NIS 80 million. The Fund transferred data on the earlier retirees. Based on these data and on the previous file, a revised actuarial opinion was prepared, which quantified the total amount of the claim on the date of its filing at approximately NIS 280 million. The Fund filed defence documents in the court, in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company. The claim was struck out after the Company erroneously filed affidavits after the required date. The Company filed an application to void the decision, and also appealed the decision.

NOTE 17 – CONTINGENT LIABILITIES

During the normal course of business, legal claims were filed against the companies in the Group, including applications for certification as class actions.

In the opinion of the managements of the Group's companies, which is based, *inter alia*, on legal opinions regarding the risks related to the claims, including the applications for certification of the class actions, appropriate provisions have been included in the financial statements (Note 15), where such provisions were required, to cover the exposure resulting from such claims.

In the opinion of the managements of the Group's companies, the additional exposure at December 31, 2007 due to claims filed against the companies in the Group on various matters and in which the likelihood of realisation is possible, amounts to approximately NIS 18.5 billion, of which approximately NIS 3.4 billion relates to salary claims filed by groups of employees or individual claims with wide ramifications. The above amounts are before the addition of interest. For the matter of a claim dismissed subsequent to the balance sheet date, see Section A(34) below.
Concerning applications for certification as class actions regarding which the Group has exposure beyond the aforesaid (since the claims do not state a specific amount), see claims in sections A(4), (5), (7) and (20) below.

Below are details of the status of the significant contingent liabilities of the Group at December 31, 2007.

A. Claims

(1) In September 2004, a claim and an application for certification as a class action were filed in the Jerusalem District Court against the Company and several other defendants (including Telrad and Tadiran) and against the State of Israel – Ministry of Communications as a formal defendant. The claim alleges that public switching cartels gave rise to unnecessary expenditure for the Company and an unjustified increase in its tariffs, in a cumulative amount of approximately NIS 1,750 million. In this matter, the Antitrust Court approved issue of an agreed order whereby the Company will pay NIS 2 million to the State Treasury without admitting violation of the provisions of the Antitrust Law, and the Antitrust Authority will refrain from instituting proceedings in connection with the matter.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims

(2) A number of claims are pending against the Company concerning recognition of various salary components as pension components and recognition of various components in the determining salary for severance pay, as follows:

a. In September 2000, a claim was filed in the Jerusalem Regional Labour Court against the Company by 2,423 retired employees of the Company who were employees transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are seeking declaratory relief from the Labour Court, such that it will be determined that the payments they received for grossing up of tax, clothing allowance and incentive pay are considered part of the regular salary and therefore should be considered as part of their determining wage for the purpose of calculating their pension and the payments made to them upon retirement, and should be included in the calculation of hourly pay value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last, determining, salary for pension should be calculated according to the last salary which was paid to each of them for the last month of work, and not according to the average staff grade which each of them held. In 2004, the Regional Labour Court ordered the claim dismissed *in limine*. An appeal filed against the decision was allowed, and the decision of the Regional Labour Court was set aside. The claim was amended so that all the reliefs relating to the pension rights of the plaintiffs were deleted from the statement of claim.

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

b. In February 2002, a notice of a party to a collective dispute ("the Notice"), was filed in the Jerusalem Regional Labour Court by the New General Federation of Workers ("the Histadrut") in the name of all Company employees. The applicant alleges that payments for grossing up of tax, the component of administrative on-call duty benefits and clothing allowances which were and are paid to Company employees, are regular pay which form part of the determining salary of each employee, including with respect to the calculation of payments upon retirement, redemption of holiday pay, grants, acclimatisation payments, percentage increments and hourly pay value, and that various payments and provisions should be made in respect thereof, including for pension purposes. The Attorney General joined the claim. In April 2006, the Jerusalem Regional Labour Court issued its decision, dismissing all parts of the claim. An appeal was filed against the decision, in which it was alleged that the decision is procedurally void, and the hearing was returned, with the consent of the parties and the Attorney General, to the Regional Labour Court.

c. In November 1995, a group of employees filed a claim against the Company in the Tel Aviv Regional Labour Court, concerning the inclusion of a number of components as part of the determining pay for pension. In August 2006, a decision was given in the case, dismissing the claim and all its component parts, and the Court ruled that the salary increments are not fictitious increments but true and conditional increments, and accordingly, are not part of the basic salary for the purpose of calculating the pension or severance pay, holiday pay and sick pay, retirement bonus and acclimatisation bonus. An appeal was filed in the wake of the decision.

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

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(2) (contd.)
The maximum total exposure in respect of the above claims is approximately NIS 3.4 billion.

(3) In September 2000, an action and an application for certification as a class action were filed against the Company in the Tel Aviv District Court. The amount of the claim is estimated at approximately NIS 110 million. According to the plaintiff, the Company unlawfully collected "collection fees" for Company bills which were not paid by their due date, since in fact the Company took no collection action until 14 days after the last date for payment as written in the telephone bill. The Court certified the claim as a class action suit. The Company filed an application for leave to appeal in the Supreme Court, which returned the case to the District Court for reconsideration of the application for certification in the accordance with the Class Action Law.

In October 2001, an additional class action was filed in the Tel Aviv District Court on exactly the same matter – unlawful charging of collection fees on Company bills not paid on time, before the Company had started any collection action. The amount of the class action was estimated by the plaintiff at approximately NIS 21 million. The Court approved suspension of the proceeding until after the decision on its certification as a class action or a ruling in the claim described above, due to the similarity in the cause of claim in the two cases.

(4) In September 2000, three plaintiffs filed a claim in the Tel Aviv District Court, together with an application for certification as a class action, against the Company, Bezeq International and the other international call operators, concerning the charge of VAT on international calls originating from abroad. The plaintiffs estimated the total value of the claim in millions of shekels per year. The application for certification was dismissed, and the plaintiffs filed an appeal against the decision. On April 10, 2007, a decision was given validating the procedural arrangement whereby the Company and Bezeq International would be struck out of the claim (after they undertook to transfer any amount paid to them, if paid, by the Customs and VAT Division in connection with the claim, as directed by the Court).

(5) a. In March 2003, a claim was filed in the Tel Aviv District Court (in 2007, the case was transferred to the new Central District Court) against the Company, the Broadcasting Authority and the State of Israel, by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm allegedly caused by prohibited radiation from the Hillel broadcasting station. The amount of the claim stated by the plaintiffs is "more than NIS 15 million", and the same claim notes that the plaintiffs will also petition to split the reliefs so that they will reserve the right to sue later for other financial damages which are not bodily harm, such as damage to crops and loss of value of land.

It is noted that following an application for dismissal *in limine* filed by the Company, a partial decision was given in favour of the Company, dismissing the claim of five of the plaintiffs, who died before the Company started operating the station.

b. In June 2004, another claim was filed in the Tel Aviv District Court (in 2007, the case was transferred to the new Central District Court) by 25 plaintiffs from Moshav Porath and Moshav Ein Vered, including 11 heirs to the estates of deceased persons, against the Company, the Broadcasting Authority and the State of Israel, for compensation in respect of bodily harm. The claim alleges violation of legislated duties, and/or acts of omission by the defendants in connection with the operation of the Hillel station. The amount of compensation claimed is not estimated (although the claim is in the jurisdiction of the District Court, i.e. more than NIS 2.5 million), and the compensation is based on financial and non-financial damages items which are listed in respect of each plaintiff, together with punitive compensation.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(5) (contd.)

c. In May 2005, the Company received a claim for NIS 46 million in damages, which was filed in the Tel Aviv District Court (in 2007, the case was transferred to the new Central District Court) by 14 plaintiffs who were and/or are residents of the moshavim Porath, Ein Vered, Ein Sarid and community of Kadima, against the Company, the Broadcasting Authority and the State of Israel. The claim alleges the violation of legislated duties in connection with the Hillel station, which resulted in bodily harm to the plaintiffs due to prohibited radiation.

The plaintiffs in these three claims have filed an application for consolidation of the hearings.

d. In May 2005, the Company received a claim for approximately NIS 141 million in damages, which was filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel. The claim alleges the violation of legislated duties in connection with the Hillel station, which resulted in property and financial damage. An application to split reliefs was also filed, which would enable future claims for damages. Twenty-three of the plaintiffs withdrew from the claim, and the amount of the claim of the remaining 30 plaintiffs was reduced accordingly, to NIS 35 million.

It is noted that on December 31, 2003, the Company ceased all broadcasts from the station, at the behest of the State and the Broadcasting Authority. Since that date, the Hillel station has not served as a broadcasting site.

(6) In January 2002 a claim for payment of monetary compensation of approximately NIS 57 million and for writs of mandamus were filed in the Tel Aviv District Court (in 2007, the case was transferred to the new Central District Court), by an international communications operator against the Company and Bezeq International. The claim is for damages allegedly sustained by that operator due to acts of commission and omission in connection with customer allocation to the international call operators. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company.

(7) In July 2002, the Company received a claim for monetary and declaratory relief, together with an application for certification as a class action. The claim alleges unlawful excess collection of interest in respect of arrears, also in respect of a debt which the Company collects for other communications providers. The total amount of the claim, if certified as a class action, is estimated by the plaintiffs in the tens of millions of shekels. The plaintiffs are petitioning for declaratory relief that the Company abused its monopolistic status and enriched itself unjustly. A court decision dismissed the application for certification. The decision has been appealed in the Supreme Court.

(8) On December 25, 2005, a claim was filed against the Company in the Tel Aviv District Court, together with an application for certification as a class action, under the Consumer Protection Law, 5741-1981, alleging that the Company unlawfully collects payment for surfing the internet with WOW's high-speed internet service, even though is technically unable to provide the service in certain areas at the promised speed. The plaintiffs estimate the amount of the class action at approximately NIS 100 million for all subscribers. On March 6, 2008, the application of one of the two plaintiffs for certification of the claim as a class action, was allowed for a group of subscribers defined in the court's decision. The Company, together with the external attorneys who are handling the case, are discussing the significance of the decision, as well as the possibility of appealing it.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(9) In May 2006, a claim was filed in the Tel Aviv District Court together with an application for certification as a class action under the Consumer Protection Law and the Class Action Law, alleging deception in advertising in the matter of a charge for calls from a Bezeq line to a cellular line. According to the plaintiff, the Company deceived the public in its advertisements, which stated that the price of such a call would be "approximately 44 agorot per minute", whereas the exact price per call minute was 44.57 agorot, nor did it disclose that the charge for interconnect was made according to segments of 12 seconds, which means that the actual average charge was 49 agorot per minute. The plaintiff estimates the amount of the claim at approximately NIS 68.5 million (the amount of the individual's claim is NIS 11).

(10) Various municipalities and local councils submitted demands for retroactive payments of municipal property taxes for the increased area of buildings and a change of the classification for municipal tax purposes. The demands together total approximately NIS 102 million.

(11) In May 2006, a claim was filed in the Tel Aviv District Court together with an application for certification as a class action, against HOT and against the Company. According to the plaintiff, on May 17, 2006, a fault occurred in his telephone line in the HOT network and it is possible that Company employees played some part in the malfunction. The plaintiff alleges that as a result of the malfunction, he incurred financial loss, harm to his goodwill, and distress. The amount of the claim is estimated by the plaintiff at approximately NIS 100 million (the amount of the personal individual's claim is assessed at NIS 1,000).

It is noted that on December 24, 2007, the Company received a ruling of the Antitrust Commissioner stating that the Company abused its status in the market, in contravention of Section 29A of the Antitrust Law, in that it did not respond, as required and promptly, to actions taken in a labour dispute. The ruling also states that pursuant to Section 43(e) of the Antitrust Law, the ruling would serve as *prima facie* evidence of its contents in any legal proceeding. On this matter, see also Section C(1) below.

(12) In November 2006, a claim and application for certification as a class action were filed in the Tel Aviv District Court, for the sum of approximately NIS 79 million. The claim alleges that the Company charged customers who connected to its ADSL service a monthly fee rather than a two-monthly fee, due to which they sustained losses and expenses.

(13) In November 2006, a claim and application for certification as a class action were filed against the Company in the Tel Aviv District Court, for the sum of approximately NIS 183 million, alleging unlawful collection of money in cases of disconnection due to non-payment.

(14) In August 2006, a claim was filed in the District Court against Pelephone, Cellcom and Partner, together with an application for certification as a class action ("the First Claim"). The amount of the action (consolidated against the three companies) is NIS 100 million. The claim relates to the time of termination of cellular system calls with the fixed line and it is claimed that regarding the aforementioned calls, where the cellular customer initiates the end of the call there is an excess charge until the time the call is actually ended. 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, amounting to approximately NIS 159 million, of which NIS 53 million against the Company, together with Pelephone and HOT ("the Second Claim"). In the second claim, the plaintiffs allege that when terminating a call made from a cellular line to a fixed line, if the call is ended 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. As a result, they incur a loss which is reflected in air-time costs and interconnect fees.
In a procedural arrangement reached between the parties, it was determined that the First Claim would be conducted against Pelephone and against Cellcom and Partner, and the Second Claim would be conducted against the Company and HOT.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(15) The Company has received a demand for the forfeiture of a guarantee in the amount of approximately USD 6.5 million related to a project (HBTL) in a basic telephony tender in 1995 in India, in which the Company participated, together with others. An appeal against an order given at the request of the project, preventing forfeiture of the guarantees, is being heard in the Appeals department of the High Court in Delhi. The Company has applied to the court in Delhi for release of the bank guarantees it provided. The court has not yet heard the application.

(16) In May 2007, the Company received a claim, together with an application for its certification as a class action, that was filed with the Tel Aviv District Court by a plaintiff claiming to have purchased shares of the Company in 2006. The claim was filed against the Company, two former CEOs of the Company, directors who served or are serving in the Company during the relevant period, as well as Ap.Sb.Ar. Holdings Ltd., which holds 30% of the Company's shares.

The claim alleges that the Company's financial statements for the years 2004 and 2005 contained false and misleading material information, including with regard to the annual profit, the property, plant and equipment and the shareholders' equity, in light of a retroactive deduction of approximately NIS 320 million in respect of property, plant and equipment that was not in use by the subsidiary Pelephone Communications Ltd.

The amount of the personal claim is NIS 194, and the total amount of the claim for the group is NIS 56.5 million.

(17) In August 2007, the Company received a claim together with an application for certification as a class action, which was filed against the Company in the Tel Aviv District Court by a plaintiff alleging to be a customer of the Company, who signed a contract with the subsidiary DBS for receipt of high-speed internet infrastructure services (ADSL). The plaintiff is seeking reimbursement of all the fixed monthly payments he made for maintaining a landline for which he no longer has any use. He contends that these payments were collected unlawfully since from the technological aspect, high-speed internet can be provided without the landline being used. According to the plaintiff, all the customers of the Company and/or of DBS who subscribed to the Company's high-speed internet service during the past two years and who requested that the Company's landline be disconnected and/or who ceased to use it but continued making the fixed monthly payments for it, have the right of such a claim. The plaintiff is seeking certification of the claim as a class action in the name of the customers referred to above, and he estimates the amount of the class action at approximately NIS 108 million.

(18) In September 2007, a claim was filed against the Company in the Tel Aviv District Court, with an application for certification as a class action, concerning the collection of VAT on arrearage interest and on charging collection expenses and commissions. The amount of the class action is estimated at approximately NIS 114 million.

(19) In November 1997 a claim was filed in the District Court, together with an application for certification as a class action, against the Company, Bezeq International, the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner had ruled that Bezeq International had abused its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs in that it refrained from clarifying to the public that only those who registered as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. In June 2001, the District Court decided to deny the application for certification. In September 2001, the decision of the District Court on this matter was appealed in the Supreme Court. The Supreme Court allowed the appeal in view of a procedural error of the District Court, and the case was returned to the District Court. In November 2005 the Court dismissed the application for certification as a class action and upheld the previous decision made by the court, adding that the application should also be dismissed since the applicant had no personal cause. In January 2006, the applicant filed notices of appeal in the Supreme Court.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

In June 2007, a hearing was held at which the Court proposed that Bezeq International publish an apology and make some kind of contribution to the community. In June 2007, Bezeq International notified the Court that there was no justification for such apology or contribution, since there was no deception and/or misleading advertising. Bezeq International also noted that in view of its respect for the Court, it would make a donation to the public, which should not be bound up with the class action. In August 2007, the Supreme Court ruled that the parties should state whether they see any need for a frontal hearing, and later the same month Bezeq International delivered a notice saying that an additional frontal hearing was necessary in the presence of the parties, in order to present the facts relevant to the proceeding and to clarify that in view of the evidence, there is no justification for certification of the claim as a class action.

(20) In September 2001, a revised statement of claim and an application for certification as a class action were filed against Bezeq International and the State of Israel. The plaintiff alleges that the tariffs for international telecommunication services during the period from May 10, 1996, through July 8, 1997, were exorbitant and unreasonable, and abused the status of Bezeq International as a monopoly, against a backdrop of falling prices as the international calls market was opening up to competition. In December 2003, the court allowed the application by virtue of the Antitrust Law and not on the basis of the cause arising from the Unjust Enrichment Law, and certified the claim as a class action. In February 2004, the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law. In January 2004, the State and Bezeq International filed applications for leave to appeal in the Supreme Court in this matter. The Supreme Court consolidated the hearings in these three cases (the appeal of the plaintiff and the applications for leave to appeal of Bezeq International and the State), and the parties filed their summations. The management of Bezeq International believes that if the claim is eventually certified as a class action by the Supreme Court and if it is allowed, the amount of the action could be in the hundreds of millions of shekels.

(21) In December 2000, a claim was filed in the Tel Aviv District Court against Pelephone by the State of Israel, in respect of royalties allegedly payable for the period from January 1994 to February 1996. The amount of the claim is approximately NIS 260 million (including principal, linkage differentials and interest).

An examination conducted as part of a mediation proceeding found that the maximum amount of royalties on the revenues of Pelephone from January 1, 1994 to February 7, 1996 is only approximately NIS 118 million (before interest and linkage).

On February 16, 2004, the Company provided an undertaking to Pelephone, as approved by the Board of Directors on February 12, 2004, that if the mediation proceeding fails, the Company will pay Pelephone any sum it is ordered to pay to the State, if charged in a peremptory decision in respect of royalties on revenues from the provision of cellular services during the period from January 1, 1994 to October 10, 1994. According to the Company, it paid the State for that period under the settlement agreement between it and the State dated November 29, 1995. The undertaking to indemnify is subject to the presentation of the Company's arguments in the proceeding, and the consent of Pelephone for the Company to join the action as a third party should the Company request to do so.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(22) In September 2001, a claim was filed in the Ram Allah District Court by the General Public Palestinian Communications Company ("Patel"), against Pelephone and another company.

The plaintiff alleges that its license grants it, *inter alia*, the full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and cellular, for the supply of fixed and cellular communications services in the territory of the Palestinian Authority for an extended period, part of which being granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its requests to the defendants, they are continuing to provide cellular communications services to the inhabitants of the West Bank and the Gaza Strip, without restraint and without a license from the Palestinian Communications Authority, thereby violating various provisions of the law, prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority and a financial action for approximately NIS 676 million from Pelephone alone.

The process of transferring the claim through the Attorney General ceased and the alternative service of process 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 learned that the Ramallah Court may have given a decision in the claim. According to the Emergency (Judea, Samaria and the Gaza Strip – Jurisdiction in offences 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 considers that such a ruling – if made – was made without jurisdiction, contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations (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 way whatsoever, Pelephone will act to prevent such approval and/or enforcement of the decision and/or execution proceedings or the 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 fact of the claim being heard in the court in Ramallah without service of process in accordance with the Order and the agreement constitutes breach of the agreement and harms the autonomy of Israel, and that any decision given in such a claim is without validity.

(23) In December 2002, a claim, together with an application for certification as a class action, was filed in the Tel Aviv District Court against Pelephone and other cellular companies, for the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone.

The claim relates to amounts collected by Pelephone and another cellular company for interconnect fees on incoming calls, from May 10, 1996 to October 2, 2000. The applicants, through their lawyers, base their claim on the allegation that every cellular operator is a monopoly in the incoming call service to its network. Pelephone and the other cellular operator abused their monopoly status in that they set high and unfair prices for the incoming call service to their networks. The correct and fair tariff for the incoming call service is 25 agorot per minute, and not as collected in the past by Pelephone and the other cellular company or as set today in the Telecommunications (Payments for interconnect) Regulations, 5760-2000.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(24) In April 2003, an application was filed in the Tel Aviv District Court for certification of a claim as a class action, in a total amount of approximately NIS 90 million, against all the cellular companies (including Pelephone among them). The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming into each of their networks. The plaintiffs allege that this is a uniform, inflated, unreasonable and unfair tariff. The period to which the claim relates is from March-June 2002 through the date of filing the claim.

(25) In July 2006, a claim and an application for its certification as a class action were filed in the District Court against Pelephone, in the amount of approximately NIS 251 million. The claim relates to the interpretation of an agreement which the plaintiff signed with Pelephone for reimbursement of payments he was charged by Cellcom when he switched from Cellcom to Pelephone. According to the plaintiff, Pelephone should have paid NIS 3,000 in respect of those payments, even though he did not comply with the terms of the agreement. Pelephone is conducting procedural discussions with the plaintiff, in view of new applications he filed for amendment of the application for the class action. Pelephone will respond appropriately when these discussions are completed.

(26) In February 2007, Pelephone received an application for certification of a class action filed against it in the Tel Aviv District Court. The claim concerns an allegation of misleading the defendant's subscribers who reside in Eilat, who were charged VAT on cellular communication service. According to the claim, this charge contravenes the law in that Eilat is a free trade zone and therefore lawfully exempt from payment of VAT. The amount of the claim is NIS 33 million. It is noted that other class actions were filed against Partner and Cellcom for the same cause and in similar amounts. The claim was dismissed in 2007 without an order to pay costs.

(27) In February 2007, a claim and an application for its certification as a class action were filed in the Tel Aviv District Court against Pelephone, Cellcom and Partner, in a total amount of NIS 449 million. The amount attributed to Pelephone is NIS 167 million. The plaintiffs are suing for restitution of excess amounts which they allege were collected from the subscribers of the defendants, claiming that the defendants charged their subscribers for a service which was provided and/or received while they were abroad, according to an increased charge (time) segment than the defendants were ostensibly permitted to charge, thereby seemingly violating the license, which prohibits them from charging their customers according to time units of one minute for roaming services.

(28) In June 2007, a financial claim and application for its certification as a class action were filed in the Tel Aviv District Court against Pelephone. The aggregate amount of the claim is approximately NIS 239 million, and it relates to a group of customers from the Russian sector of the population and the tariff tracks that were offered to them.
According to the plaintiffs, Pelephone deceived the subscribers of the "New Immigrants Plan" into believing that they would be charged on the basis of 12-second units, while in practice, they were debited on the basis of one-minute units.
It is also alleged that in order to perpetuate the deception, Pelephone did not provide the subscribers with the price list for the plan, as required under its license.

(29) In November 2007, a claim was filed against Pelephone in the Tel Aviv District Court together with an application for its certification as a class action. The amount of the class action is approximately NIS 368 million.
The application is based on the allegation that Pelephone did not fulfil its obligation to ascertain that the content services provided by external providers are provided only to those of its customers who request them. According to the plaintiffs, Pelephone violated Section 58.6 of its cellular operator license and therefore also Section 11(a) of the Telecommunications Law, and is therefore in beach of a legislated duty towards its customers.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(30) In June 2006, an application was filed in the Tel Aviv District Court for approval of a claim as a class action against DBS and against the cable companies, in connection with the broadcasting of commercials during the 2006 World Cup Games. According to the applicants, the broadcasting of commercials, which they allege were integrated into the first three days of broadcasts of the World Cup channel as part of the games and the World Cup studio, was against the law, contrary to the contract between DBS and its customers, and contrary to the terms laid down in the decision of the Council to approve the broadcasting of the 2006 World Cup Games. The applicants estimated the amount of the claim at NIS 106 million for all the members of the group (based on 200,000 World Cup subscribers of the cable companies and DBS together, calculated at NIS 530 per subscriber who purchased the World Cup package).

(31) In April 2007, an application was filed with the District Court for certification of a class action against DBS and against Sports Channel Ltd. (the producer of Channel 5, Channel 5+, Channel 5 live and Channel 5 gold) and its managers, in connection with the broadcasts of Channel 5 live ("the Certification Application"). According to the applicant, the broadcasts of Channel 5 live involve the transfer of content from Channel 5+ to Channel 5 live, which contravenes "the basic promise of DBS as ratified in earlier legal proceedings". The applicant, whose cause of claim against DBS is violation of a contractual obligation, breach of the duty of good faith in a contractual engagement and unjust enrichment, estimates the amount of the action at approximately NIS 63 million.

(32) During October 2007, two applications for certification of claims as class actions were filed in the District Court against DBS, in the matter of broadcast interference. The plaintiffs allege that because in September 2007 DBS subscribers were subjected to daily disruptions and long breaks in television broadcasts which severely disrupted the picture and sound, and that the DBS service centre malfunctioned and neither service nor assistance were available. The plaintiffs are seeking restitution, compensation or credit in the full amount of the monthly subscriber fees paid to DBS for September 2007, for all those who were subscribers at that time.
The plaintiffs estimate the loss for one claim at NIS 103 million and for the other at NIS 66 million.
On January 16, 2008, the applicants filed a notice in the court, stating that the actions would be conducted in only one claim. The date for filing DBS's response to the application for certification was set for March 31, 2008.

(33) In July 2007, a statement of defence was filed on behalf of an entity that had been sued by DBS, and concurrently it filed a counter-claim against DBS and another company for approximately NIS 43 million. In the statements of defence and counter-claim, it was alleged that the liability for the failures in the decoders supplied to DBS is not that of the entity but devolves on DBS and/or another company since the entity alleged, *inter alia*, the decoders were not properly characterised by the defendants and were not tested as required, and in at least some of the cases were not properly installed in the DBS subscribers' homes. In view of these allegations, the counter-plaintiff alleged various losses related to repair of the decoders even beyond the contractual warranty period, in the supply of spare parts, in providing manpower services and in various payments it made to the other company. Alternatively, the counter-plaintiff is suing for lost expenses and loss of profits, which it allegedly incurred. On November 1, 2007, an application was filed on behalf of DBS for amendment of the statement of defence and the statement of counter-claim filed by the aforementioned entity, since they were not in compliance with the Civil Procedures Regulations. Concurrently, an application was filed on behalf of DBS for postponement of the date for filing its statement of reply and statement of defence in the counter-claim, until a decision is handed down in the application for an order as aforesaid. No decisions have been received on these applications.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(34) In November 2006, the claim and application for certification as a class action were filed in the Jerusalem District Court for the sum of approximately NIS 10.6 billion, against the Company, HOT, Pelephone, Cellcom and Partner, concerning the failure to implement number portability. According to the plaintiffs, each of the 10.6 million subscribers of the aforementioned companies incurred a loss of NIS 1,000. Accordingly, the exposure of the Company (since it has approximately 2.9 million subscribers), is NIS 2.9 billion, while that of Pelephone (which has approximately 2.6 million subscribers) is NIS 2.366 billion. On March 5, 2008, the court approved the withdrawal of the applicants from the application for certification of the claim as a class action, and instructed that the application be struck out, and in accordance with the consent among the parties, it dismissed the personal claim of the applicants.

(35) Miscellaneous claims – Various claims are pending against the Company and the Group companies arising from the normal course of business. It is the opinion of the companies' managements that the latent risk in each of these claims will not cause material financial losses beyond the amounts included in the financial statements.

B. Claims in respect of which the exposure cannot yet be assessed or in respect of which the exposure cannot be calculated

Claims in respect of which the exposure cannot be calculated

(1) In January 2004, a claim was filed in the Tel Aviv Regional Labour Court against the Company and against the Makefet Fund, by employees who retired under a retirement agreement signed in November 1997. The plaintiffs allege that they chose the Pension Track B after having been promised an increment pursuant to the "Yellow Note" agreement, and that this promise was not kept. The claim was originally filed by 66 retirees and today, the number of plaintiffs is approximately 320.

(2) In July 2004, an action for declaratory relief was filed in the Tel Aviv Regional Labour Court against the Makefet Fund, the State of Israel and the Company, by the Organization of Bezeq Retirees and six of its members, alleging that the defendants breached agreements for binding arrangements that were made upon the transfer of the employees from the Civil Service to the Company. According to the plaintiffs, their rights as retirees were acquired by the State and the Company in full actuarial balance and under binding agreements, and therefore, the pension reform that followed a change in legislation on June 1, 2003, does not apply to them.

(3) In December 2007, a claim and an application for its certification as a class action were filed against Pelephone in the Tel Aviv District Court, in the amount of approximately NIS 37 million. The principal allegation in the claim is that Pelephone decided unilaterally, commencing June 2007, to add all its telephone lines which pay only for call minutes without a commitment, to a plan called the "Basic Diminishing Tariff", and to charge those who subscribe to it a monthly fee of NIS 12.90.

(4) In December 2005, an application was filed in the District Court for certification of a claim against DBS as a class action. The reliefs applied for are as follows:

a. Monetary compensation for every customer who entered into an agreement with DBS by telephone and not in writing (leaving the amount to the discretion of the court. In the plaintiff's personal claim, NIS 20,000 is requested in compensation.)
b. Financial compensation in the amount which was overcharged, for whoever actually paid more than the amount agreed upon by telephone with DBS's service representatives.
c. A declaratory order to DBS determining that from now on, whoever enters into an agreement with it by telephone will receive the arrangement in writing within 21 days.

On March 8, 2006, DBS filed an application for removal of the claim as a class action. On April 11, 2006, the applicant filed its response, in which dismissal of the application was allowed without any decision having been given.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

B. Claims in respect of which the exposure cannot yet be assessed or in respect of which the exposure cannot be calculated (contd.)

Claims in respect of which the exposure cannot yet be assessed

(1) In December 2007, a claim was filed in the Tel Aviv District Court against Pelephone, Cellcom and Partner, together with an application for certification as a class action, in the amount of NIS 1 billion. The claim relates to radiation injury from cellular antennae which were ostensibly erected unlawfully. Pelephone is studying the claim.

(2) In January 2008, a claim was filed in the Tel Aviv District Court against Pelephone and another company, for physical injury due to exposure to radiation during the plaintiff's work with fire extinguishing systems in the relay stations of the Company. Pelephone is studying the claim.

(3) A number of proceedings have been served on Pelephone, in which local councils are seeking to add Pelephone as a party to various appeals filed in the Appeals Committee against dismissal of impairment of value claims under Section 197 of the Planning and Construction Law, due to the erection of communications installations. Pelephone studies each application on its merits, and decides on its course of action accordingly.

(4) On March 10, 2008, the Company received a counter-claim which was filed in the Tel Aviv District Court by HOT Telecom Limited Partnership against the Company and the subsidiary Bezeq International. The counter-claim was filed together with a statement of defence of HOT Telecom in the claim field against it by Bezeq International (in which Bezeq International alleged discrimination in contravention of HOT Telecom's license). In the counter-claim, HOT is suing for monetary losses it allegedly incurred in respect of Bezeq International's marketing of fixed-line telephony in PRI channels; deliberate disruptions in interconnect between the Company's network and the HOT network; the Company's failure to provide naked ADSL service by Bezeq; receipt of confidential information about HOT's customers by unlawful means by Bezeq International. The stated amount of the counter-claim for fee purposes is NIS 30 million.

C. Other contingencies

(1) On May 2006, investigators from the Antitrust Authority appeared in the Company's offices and presented an order of the Magistrate's Court permitting them to search the Company's offices and seize any document or object required for the investigation. According to the order, the cause of its grant was suspicion of abuse of status by a monopoly according to Section 29A of the Antitrust Law and Section 47(a)(4a) of the Antitrust Law, 5748-1988 ("the Law"), and/or unreasonable refusal to provide an asset or service which is provided in monopoly, according to Section 29 of the Law. During the search, the investigators collected various documents, including computerised material, and a number of employees were called for questioning at the Antitrust Authority offices. The Company cooperated fully with the Authority investigators.

The Antitrust Commission announced that it had completed its investigation.

On December 24, 2007, the Company received a ruling from the Antitrust Commissioner, as authorised under Section 43(a)(5) of the Law, given after having considered the Company's arguments and finding them insufficient to prevent the ruling from being given. The ruling states that the Company abused its status in the market, contrary to Section 29A of the Law, in that it did not respond to steps taken during a labour dispute by its employees, in connection with the activities of other communications operators, and in that it was not prepared, according to the ruling, to apply immediately to the Labour Court in the matter of the disconnection between its network and the HOT network. It is noted that the Company filed its application for an injunction in the Labour Court towards midday on May 18, 2006, the day after the malfunction commenced in the HOT network (during the afternoon of May 17, 2006).

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

(1) (contd.)

The ruling also stated that pursuant to Section 43(e) of the Law, this ruling would serve as prima facie evidence of its contents in any legal proceeding, and that pursuant to Section 43(f) of the Law, the exercise of the Commissioner's authority according to Section 43, or its non-exercise, is no impediment to bringing suit against a person who committed an offence against the Law.
The Company intends to file an appeal against the Commissioner's ruling.

It is noted that in May 2006, a claim and application for certification as a class action were filed against the Company and against HOT, in the matter of a malfunction in the telephone line in the HOT network on May 17, 2006. On this matter, see Section A(12) above.

(2) a. The Company received a letter on March 15, 2007, from a shareholder of the Company pursuant to Section 194 of the Companies Law, in which the Company is required to institute legal proceedings against the former CEO of the Company and the former VP Marketing of the Company, on the matter of the debts of a consolidated company, DBS, to the Company, and to take action for the collection of the debts of DBS to the Company. The Board of Directors of the Company rejected this demand out of hand, since, among other reasons, the debts were generated as a result of lawful activities of DBS as a marketer for the Company, and the Company is acting to collect the debts, and has even reached a payment arrangement with DBS and DBS is repaying its debts regularly in accordance with the arrangement. The author of the letter (the shareholder) was notified of the decision. Subsequently, the shareholder decided to sue the Board of Directors of the Company for retroactively approving transactions which were mentioned in his first letter. The Board of Directors rejected this letter also.

b. On September 20, 2007, another letter was received from the same shareholder pursuant to Section 194 of the Companies Law, in which he demanded that the Company institute legal proceedings against members of the Board of Directors of the Company who, according to the shareholder, approved the injection of Company monies into DBS, contrary to the decisions of Ministers of Communications, thereby incurring losses of NIS 10 million for the Company (the amount which the Ministry of Communications announced at the time it would render forfeit from the Company's guarantee). The Board of Directors of the Company discussed this letter and decided to reject it. It is noted that the petitions of the Company and DBS against the Minister of Communications in the matter of the Company's injections of funds to DBS, were dismissed *in limine* in September 2007. The Company also filed an appeal in respect of the intention to forfeit the guarantee. The appeal was discussed with the Minister of Communications, and the Company believes that the guarantee will be forfeited. The financial statements include a provision which the Company's Management considers appropriate.

(3) In May 2007, the Company received a letter pursuant to Section 194 of the Companies Law, which was sent by a claimant who said she is a shareholder of the Company from the public. According to the letter, following the findings of the external examiner appointed by the Company to examine the manner in which various decisions are made and the way the Company is run, which indicate a multitude of shortcomings and failures related directly to the work of the Board of Directors, its committees, its members and the former CEO of the Company, the Company was requested to institute legal proceedings against the Board of Directors and the Company's other officers who were responsible for those shortcomings and failures. The Company's Board of Directors rejected the demand outright, and informed the claimant to that effect.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

(4) In August 2005 a claim was filed against the Government of Israel, the National Council, the Ministry of the Interior, the head of the Noise and Radiation Abatement Division (at the Ministry for Protection of the Environment), the cellular companies, including Pelephone, and a company named Elidav – Building & Investments Ltd. (the owner of a house in Ramat Hasharon on the roof of which cellular antennae were installed). The claim concerns the liability for claims under Section 197 of the Planning and Construction Law for the issue of building permits for cellular antennae. The central allegation in the claim, as far as the cellular companies are concerned, is that in the proceedings for approval of National Outline Plan 36A, the cellular companies undertook to indemnify the local committees in respect of compensation those committees would be ordered to pay in claims under the aforementioned Section 197, and that the National Outline Plan was approved on the basis of that undertaking. According to the plaintiffs, the undertaking is tantamount to "a contract in favour of a third party" in their favour and in favour of the other local committees.
The plaintiffs also allege that the Government and the National Council were negligent in that they did not anchor that undertaking in the National Outline Plan, and once it transpired – after approval of the Plan – that the cellular companies were unwilling to indemnify the local committees, the Government and the National Council should have cancelled or suspended the Plan and should also have cancelled the franchises of the cellular companies.

The plaintiffs are petitioning for a large number of reliefs (about 20), all declaratory. The principal reliefs are to declare that the cellular companies and the other defendants must pay the compensation ruled against the local committees in claims under the aforementioned Section 197.

(5) In 2001, the Ministry of Communications issued administrative directives which regulate how a subscriber switches from the services of the cable companies to DBS and vice versa, and the use of infrastructures in the subscriber's home. The directives also prescribe a duty to pay monthly usage fees for infrastructure owned by the other multi-channel television service provider. Since the administrative directives were issued, DBS and the cable companies have submitted mutual complaints of violation of the directives by the other party, and voluminous correspondence has been exchanged between DBS and the Ministry of Communications on the matter. On August 15, 2005, the Ministry of Communications notified DBS and the cable companies that in view of their numerous violations of the administrative directives, it had re-examined the matter and was now considering their cancellation, *inter alia*, in view of the mechanism for purchasing the wiring prescribed in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120.

On November 2, 2005, DBS submitted its position to the Ministry of Communications, stating that the administrative directives should remain in place, while cancelling the early notice prescribed in them, which requires that notice be given to a party whose subscribers disconnect from its services. DBS also contended that the provisions of the law granting ownership of infrastructure to the multi-channel television provider that installs it in the homes of its subscribers, should be rescinded. At the very least, contended DBS, if the directive remains in place, its proper interpretation should not grant the cable companies ownership of the wiring it installed in private houses. DBS also stated that the amount prescribed in the law as the consideration to be paid for purchasing the wiring (NIS 120), is baseless and that if the directive is retained, the amount should be considerably reduced.

(6) In June 2005, the cable companies ("HOT") filed an *ex parte* application in the Tel Aviv District Court ("the First Application"), in which the court was requested to grant, among others, an order for the appointment of a receiver, who would be authorised to search and seize, at all the sites held by DBS, commercial secrets of HOT as well as other information of HOT which is confidential or restricted by law, as well as other temporary reliefs, principally to prohibit DBS from using the commercial secrets of HOT.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

(6) (contd.)

The background to the filing of HOT's application was the publicity given in the press to the industrial espionage affair by means of Trojan horse software, where according to HOT, DBS ostensibly acted unlawfully, through the Modi'in Ezrachi investigation firm with which it had engaged, to enable it to obtain confidential information of HOT, thereby committing the tort of robbery of a commercial secret.

After dismissal of its application, HOT filed a "revised" *ex parte* application ("the Second Application"), in which it reiterated its First Application, this time noting that its allegations were not based only on media reports, as it had alleged in the First Application, but on information provided by Israel Police. Simultaneously, HOT filed a statement of claim against DBS, which does not include an application for any financial relief, in which the court is requested to grant a number of declaratory reliefs, mandamuses and injunctions concerned with prohibiting DBS from making use of commercial secrets of HOT.

In its response to the application, DBS rejected HOT's allegations and gave notice that without waiving any of its arguments, it was willing to undertake to refrain from making any use of documents related to HOT's business which had come into its possession from Modi'in Ezrachi, and that should any such document or information be found, that document would be sealed in an envelope and placed in a safe. On July 7, 2005, the court, with the consent of the parties, gave a decision, which validated as an order, DBS's notice not to make any use of documents and information transferred to DBS by Modi'in Ezrachi. In practical terms, this means that the court dismissed HOT's applications for appointment of a receiver and for grant of a temporary injunction of broader scope than DBS's commitment.

On June 30, 2005, DBS filed a defence in court, in which it denied the allegations in the claim made by HOT. A hearing has not yet been scheduled.

On July 12, 2005, HOT filed an application to split reliefs so as to enable it to file a financial claim against DBS in a separate claim. On September 18, 2005, DBS filed a response, requesting the dismissal of HOT's application. On September 5, 2006, the court issued a decision directing HOT to give notice of whether it intends to continue with its application to split reliefs. On September 26, 2006, HOT filed notice in court that it intends to continue with the application and that it requests that the court allow the application as is until the pre-trial date of the claim. On the same date, the court gave its decision allowing HOT's request to leave the application as is until the pre-trial date. The first pre-trial hearing was postponed to the beginning of March 2008.

On March 3, 2008, the legal representative of DBS appeared for the pre-trial hearing of the case, whereas the legal representative of HOT was absent. In its decision, the court ruled that HOT must show cause, within 14 days, why the action should not be dismissed or struck out for failure to appear, and alternatively, why court costs should not be ruled in DBS's favour and/or in favour of the State Treasury.

In addition, in November 2005, a claim was filed in the Tel Aviv District Court against Pelephone, for an order to provide a financial report, together with an application to split reliefs. The cause of claim revolved around allegations whereby, as it were, Pelephone had "ordered" business information about the Plaintiff's business and this was supplied by defendant no. 2 (Modi'in Ezrachi) by way of violating a number of provisions of law and as part of the Trojan horse affair.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

(7) For the provision of their services, the Company and the subsidiary Pelephone operate installations which emit electromagnetic radiation. The operation of such installations is subject to the Non-ionizing Radiation Law, 5766-2006, the majority of whose provisions came into force on January 1, 2007 ("the Radiation Law"), and the Pharmacists (Radioactive elements and their products) Regulations, 5740-1980, which regulate the erection, operation and supervision of these installations, including a requirement for permits for that purpose. Erection and operation permits are granted by the Supervisor of Radiation at the Ministry for Protection of the Environment, and grant of an operator's license necessitates presentation of a permit under the Planning and Construction Law. The Company and Pelephone are at an advanced stage of preparation and adaptation of their installations for operation in accordance with the provisions of the relevant laws. The subject of electromagnetic radiation and its effects has not yet been thoroughly investigated in Israel or elsewhere. In the first half of 2007, the Company applied for operating permits from the Supervisor of Non-Ionizing Radiation at the Ministry for Protection of the Environment, and all in accordance with the Radiation Law which came into force at the beginning of 2007. As a result of this activity, the Company received operating permits for its communications installations, except for an isolated few for which a radiation permit remains in effect under the Pharmacists Regulations. The Company has applied for operating permits in respect of these few installations also. In January 2008, drafts of National Outline Plan 36A and National Outline Plan 36B were published, which regulate licensing proceedings, in accordance with the Planning and Construction Law, of small and large radiation-emitting installations. The Company is reviewing the significance of the amendments inserted into these drafts, their effects on its installations and possible ways of changing certain provisions.

The Company and Pelephone are using their best efforts to meet the requirements of the Radiation Law, including concerning the permits required. Nevertheless, the managements of the Company and Pelephone are unable to assess whether all the approvals will be received within the time prescribed in the Radiation Law, and what the implications of the aforementioned might be.

(8) In connection with the number portability plan of December 2, 2007, which enables customers to switch between various communications operators without changing their telephone number, the petitions filed in the Supreme Court by the cellular companies and by the Company, were withdrawn with the consent of the parties while reserving their rights, and the proceedings were terminated.

On May 24, 2007, the Company received a notice from the Director General at the Ministry of Communications, stating that he was considering imposing financial sanctions on the Company pursuant to Chapter G1 of the Communications Law, 5742-1982, in respect of violation, he alleged, of the duty to provide number portability commencing September 1, 2006, as follows:

a. For the period from September 1, 2006, to the date of the Director General's notice, a financial sanction of NIS 2,031,750.
b. For the period from May 25, 2007, to November 30, 2007 or until the date of remedy of the alleged violation (whichever is the earlier) by the Company – a rate of NIS 6,450 for each additional day of continued violation.
c. For the period from December 1, 2007 (which, according to the letter, is the reasonable date required for the relevant license-holders to remedy the alleged violation) to the date of remedy of the alleged violation – a financial sanction as set out in Sections 37B(b) and 37C(a) of the Communications Law after Amendment 36 (it is noted that under the provisions of those sections, the relevant sanction is seven times higher than the penalty prescribed in Section 61(a)(4) of the Penal Law (which is NIS 202,000), plus 0.25% of the Company's annual income, plus a financial sanction in the amount of one fiftieth of the aforementioned sanction, for each day on which the violation continues).

The Company, Pelephone and Bezeq International (which received similar notices) have responded to the notices of the Ministry of Communications.

NOTE 17 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

(9) In November 2007, a claim and an application for its certification as a class action were filed against Pelephone in the Tel Aviv District Court, in the amount of NIS 12 billion.
The claim is without cause. Pelephone and its legal advisers believe that the claim will be struck from the calendar.

(10) On November 27, 2007 and on January 31, 2008, one of the DBS shareholders (through her lawyer) approached the Company and another DBS shareholder, demanding the appointment of an arbitrator and/or compensation in the amount of NIS 124 million for losses she had allegedly incurred as a result of the conduct of the Company and the other shareholder in DBS in all matters relating to the management of DBS and the use of DBS to promote objectives which are foreign to the shareholders agreement. The Company rejected the approaches, following which, on February 28, 2008, in connection with an application was filed in the Tel Aviv District Court for the appointment of an arbitrator.

(11) Concerning class actions filed against DBS in respect of broadcast disruptions, see Section A(32) above.

(12) For possible demand for early repayment of bank loans, see Note 13.

D. Claims in an associate

(1) In July 2007, a claim was filed in the Jerusalem District Court against an associate of Bezeq International, the Israeli Police, the State of Israel and 7 other defendants from the field of communications, in a total amount of more than NIS 65 million, for physical injury ostensibly sustained by the plaintiff following the publication of libel and slander concerning his involvement in securities crimes and conspiracy to commit murder. On October 22, 2007, the associate filed an application for extension of the date for filing a statement of defence.

In the opinion of the associate and its legal advisers, since the claim is not supported by concrete evidence and since the associate is not the principal defendant, the likelihood of the claim against the associate being allowed is remote, and therefore the associate has made no provision for it in its financial statements.

(2) On September 4, 2007, an application for certification as a class action was filed in the Tel Aviv District Court against 70 respondents, including operators of e-trade sites, among them an associate of Bezeq International and suppliers who offered products for sale through those sites. According to the applicants, the respondents operate ostensibly "fictitious offerors" who make "fictitious offers" in auctions conducted on the sites, in order to prevent participants in the auctions from winning them at prices which the respondents consider too low, and in so doing, they applicants allege, they are acting in breach of contract and deceitfully under the Consumer Protection Law. The reliefs applied for by the applicants include orders prohibiting the respondents from interfering in auctions and unquantifiable financial reliefs. On October 15, 2007, the Court gave an interlocutory order that includes the prohibition of the deletion and/or change of sale data.

In view of the preliminary stage of the proceeding, the likelihood of the application being certified as a class action cannot be assessed; however, in the opinion of the associate's legal advisers, the associate has reasonable defence arguments, both against the certification and against the claim itself.

NOTE 18 – COMMITMENTS

A. Engagements in lease agreements and rentals

Contractual rental payments during the next 5 years, are calculated according to the rent in effect at December 31, 2007 are as follows:

For the year ended December 31,	NIS millions
2008	**163**
2009	**182**
2010	**145**
2011	**83**
2012 onwards	**131**
	704

B. At December 31, 2007, DBS has agreements for the purchase of broadcasting rights. In the year ended December 31, the purchase of these rights amounted to approximately NIS 122 million.

C. (1) DBS entered into an agreement for leasing space segments of the Amos 1 satellite with Israel Aircraft Industries ("IAI") commencing April 14, 1999. The term of the lease will end on June 30, 2009 or at the end of the life of the satellite, whichever is the earlier.

(2) In addition, on May 16, 2001, DBS entered into an agreement with H.L.L. Spacecom Satellite Communications Ltd. ("HLL"). The term of the lease will end 12 years after the satellite is positioned in space or at the end of the life of the satellite, whichever is the earlier. The satellite was positioned in space in April 2004.

The projected annual lease fees in the coming years under those agreements are as follows:

	NIS millions
2008	**101**
2009	**100**

In May 2003, an agreement was signed with IAI, regulating the debts of DBS in respect of leasing the space segments for the period up to May 2002. At the date of approval of the financial statements, only partial payment has been made on account of the lease fee debt for the prior periods which are overdue. In view of DBS's arrears in the payments prescribed in the above agreement, in March 2006 IAI demanded settlement of the entire debt and the interest on it. Since IAI's demand, DBS and IAI have been negotiating settlement of the debt. In accordance with the aforementioned, the balance of the liabilities is shown under short-term borrowing, including a provision for arrearage interest in accordance with an assessment made by DBS's Management.

In addition, DBS and HLL are in dispute in respect of the amount of the annual payments, and DBS's entitlement to a certain discount on the lease fees.
In February 2008, a settlement agreement was signed between DBS and HLL for cessation of the arbitration proceeding between the parties concerning the amount of the monthly payment due to HLL for the lease of space segments in the Amos 2 satellite.

D. The Group has a number of operating lease agreements for periods of 3 to 4 years in respect of vehicles it uses. The contractual annual lease fees, calculated according to the fees in effect at December 31, 2007, are approximately NIS 215 million.

E. In accordance with the requirements of the license and the principles laid down by the Council for Cable and Satellite Broadcasts, in 2006, 2007 and 2008, DBS must invest in content broadcasts not less than 8% of its revenues from subscriber fees in local productions.

F. At December 31, 2007, DBS has agreements to buy purchased channels. In the year ended December 31, 2007, the expenses for consumption of purchased channels amounted to approximately NIS 227 million.

NOTE 18 – COMMITMENTS (CONTD.)

G. Right to purchase a usage right in frequencies

In 2001, the band of frequencies in which Pelephone was granted rights when it won a tender published by the Ministry of Communications (see Note 33(1)), which it would use in HSPA/UMTS technology for the new frequency range was made subject to terms which include, among others, payment of NIS 225 million (plus Accountant General's interest, except on the first, index-linked payment),and provision of a guarantee in the amount of USD 20 million to secure the terms of the license, which was amended in 2004 to USD10 million. The payment due upon winning the tender was supposed to have been made in six different instalments, spread over the period through 2006.

On March 16, 2004, Pelephone agreed to a proposal of the Ministries of Communications and Finance concerning a reduction of NIS 33 million from the original payment set in the frequencies range tender, against (1) payment of the balance of the license fee of approximately NIS 99 million during 2004; (2) return of the frequencies to the State, so that Pelephone would not owe payment of frequency fees for them from 2003 onwards.

In addition and concurrently, Pelephone was granted a right to a future allocation of these frequencies, for the exercise of which, Pelephone would pay the amount deducted plus the frequency fees in respect of the relevant period, plus customary linkage differentials and interest. Between March and August 2004, Pelephone paid the aforementioned balance of the license fee in the amount of NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Ministry of Communications, informing it that in an amended calculation made by the Ministries of Communications and Finance, the amount Pelephone would be required to pay upon future allocation of the frequencies, is NIS 51 million, and not the NIS 33 million agreed in March 2004. Pelephone has not presented its position on this to the Ministries.

As part of its preparations for setting up a network in HSPA/UMTS technology (see also Note 9G above), Pelephone intends to exercise the right to purchase the frequencies.

H. In February 2004, Bezeq International entered into an agreement with Mediterranean Nautilus Ltd. ("Med Nautilus"), for the purchase of an indefeasible right to use sea-bed cable capacity. In addition, the agreement grants Bezeq International options for an additional purchase from Med Nautilus of an indefeasible right to use sea-bed cable capacity. Some of the options were exercised in 2004, and the remainder were exercised in June 2006. In October 2006 another agreement was signed with Med Nautilus, for an additional purchase of an indefeasible right to use sea-bed cable capacity in 2007, in a total amount of approximately NIS 74 million. This agreement also grants an option for an additional purchase of capacity from Med Nautilus in the future.

I. For engagements for the purchase of property, plant and equipment, see Note 9H above.

NOTE 19 – SECURITIES, LIENS AND GUARANTEES

A. In May 2003, the Company provided, at the behest 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. On June 22, 2005, the Company received a letter from the Director General of the Ministry of Communications, giving notice of the decision of the Ministry to call in NIS 10 million of the USD 10 million bank guarantee provided by the Company in connection with its general license. The Director General's letter stated that the decision to foreclose was made in light of the fact that the Company had made commitments to the institutional investors who provided loans to DBS, in which the Company holds 49.8% of the share capital, in a way which contravenes the directives of the then Minister of Communications.

NOTE 19 – SECURITIES, LIENS AND GUARANTEES (CONTD.)

A. (contd.)

It is noted that since the then Minister of Communications made her decision to impose restrictions and conditions on the Company's injections to DBS, both DBS and the Company acted without relating to their legal position, with the purpose of complying with the conditions and restrictions imposed by the Minister of Communications and at the time also by the Antitrust Commissioner, as well as the legal action they had instituted both in the High Court of Justice (the petitions of the Company and DBS have since been dismissed) and in the Antitrust Court (in a proceeding which has already been terminated, since the term of the restriction imposed by it had elapsed).

B. The Company provided a guarantee in favour of banks in connection with credit of up to NIS 70 million granted to a subsidiary.

C. For guarantees provided by the Company for its past investments in India, see Note 17A(17).

D. The Company provided a guarantee of approximately NIS 10 million for DBS in respect of a bank guarantee of approximately NIS 33 million which DBS had provided in favour of the State of Israel. The guarantee is valid until December 31, 2010.

E. In February 2002 and May 2005, at the demand of the Ministry of Communications, Bezeq International provided bank guarantees of approximately NIS 9.4 million and NIS 1.4 million respectively, for fulfilment of all the terms of the license to provide international telecommunication services. In December 2004, at the behest of the Ministry of Communications, Bezeq International provided a bank guarantee of approximately NIS 340,000 for fulfilment of the terms of a special license granted it for a marketing trial for the provisions of VOB services. At the balance sheet date, Bezeq International had provided additional bank guarantees in a total amount of approximately NIS 11 million.

F. Pelephone provided guarantees of approximately NIS 71 million in favour of third parties, of which approximately NIS 38 million in favour of the Ministry of Communications, in connection with a guarantee for fulfilment of the terms of its license.

G. To secure its liabilities, DBS provided documentary credit and guarantees amounting to approximately NIS 40 million (including a bank guarantee of NIS 36 million in favour of the State of Israel).

H. The shareholders in DBS (except for one of them) have mortgaged their shares in favour of the banks. In view of a negative mortgage of the Company (see Note 13), the Company provided the banks with a perpetual guarantee for payment of the debts of DBS. The guarantee is up to a maximum amount equal to the percentage of the Company's holding in DBS, multiplied by the value of DBS as derives from realisation of the mortgaged shares of the other shareholders. If the Company joins the sale in the framework of realisation of the mortgaged shares of the other shareholders, the amount of the guarantee will not exceed the amount of the proceeds the Company will receive from realisation of its shares in DBS. The note of guarantee includes numerous restrictions on the Company in realising the shares it holds, and lists events of violation which, if committed, will enable the banks to call in the guarantee. Furthermore, the Company also undertook to put its shares up for sale if the shares mortgaged by the bank are sold, and agreed that in case of realisation of collateral provided by the other shareholders, the Company would forgo repayment of shareholder loans provided for DBS and that the guarantee would apply, *mutatis mutandis*, also to stock options which the Company receives from DBS and to the right to receive them.

Except for one, the shareholders in DBS, have made a commitment to the banks not to oppose the sale or other realisation of their shares in DBS, which were mortgaged or for which a guarantee was provided (by the Company), in a way that will enable the banks to accomplish a friendly liquidation.

I. For securities, charges and stipulations given by the Company and subsidiaries in connection with loan covenants and borrowings, see Note 13.

NOTE 20 – SHAREHOLDERS' EQUITY

A. Share capital

	Registered		Issued and paid in	
	December 31, 2007	December 31, 2006	December 31, 2007	December 31, 2006
	No. of shares	No. of shares	No. of shares	No. of shares
Ordinary shares of NIS 1 par value	**2,749,000,000**	2,625,000,000	**2,605,045,611**	2,605,045,611

B. Following completion of the sale of 30% of the State's shares in the Company to Ap.Sb.Ar. (see also Note 1) on October 11, 2005, the State's holdings in the Company decreased to approximately 16%. Ap.Sb.Ar. has an option to purchase 10.66% from the State on terms that have been determined.

C. The Board of Directors of the Company, at its meeting on March 1, 2006, decided that resolutions concerning distribution of a dividend would be passed on a specific basis, in accordance with the financial results of the Company, its financial situation and other relevant circumstances and data. This resolution superseded earlier resolutions in the matter of dividend policy.

D. The Company also issued stock options to employees, managers and senior employees in the Group (see Note 26).

Capital reserve for assets available for sale
A fair value reserve includes the net cumulative change in the fair value of financial assets available for sale, until the assets are disposed of.

Capital reserve for activities between the Company and a controlling shareholder
This reserve relates to benefits granted by the State as controlling shareholder in the Company, to employees, in cash and in equity instruments of the Company.

Capital reserve for employee stock options
This reserve relates to a benefit granted to employees by means of share-based payments.

Dividends
The following dividends were announced and paid by the Company:

	For the year ended December 31	
	2007	2006
	NIS millions	NIS millions
In February 2007, a cash dividend was distributed (NIS 0.69 per share)(1)	**1,800**	-
In October 2007 a cash dividend was distributed (NIS 0.29 per share)	**760**	-
In April 2006 a cash dividend was distributed (NIS 0.46 per share)	-	1,200
In October 2006 a cash dividend was distributed (NIS 0.15 per share)	-	400
In November 2006 a dividend was declared (NIS 0.12 per share)(2)	-	300
	2,560	1,900

(1) On December 28, 2006, the general meeting of the shareholders of the Company approved the recommendation of the Board of Directors of the Company concerning distribution of a cash dividend of NIS 1,800,000,030 (comprising NIS 0.69 per share), as a distribution not in compliance with the earnings test. The distribution was subject to the approval of the court. On February 4, 2007, the court approved the distribution, and the distribution was made on February 26, 2007.

(2) The dividend was paid in January 2007.

E. On February 1, 2007, the general meeting of the Company approved an increase in the registered capital of the Company by 124,000,000 ordinary shares of NIS 1 par value each, which will be equal in all their rights to the ordinary shares of NIS 1 par value of the Company, so that together with the balance of the existing registered capital, the registered capital of the Company will be 2,749,000,000 ordinary shares of NIS 1 par value each.

NOTE 20 – SHAREHOLDERS' EQUITY (CONTD.)

F. On March 10, 2008, the Board of Directors of the Company resolved, and recommended to the general meeting of the shareholders of the Company, to distribute a cash dividend to the shareholders in the amount of NIS 679 million (representing NIS 0.26 per share).

NOTE 21 – REVENUE

	For the year ended December 31		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Fixed-line domestic communications			
Landline telephony	**3,798**	4,068	4,251
Internet – infrastructure	**711**	606	543
Transmission, data communication and others	**935**	895	862
	5,444	5,569	5,656
Cellular telephone			
Cellular and terminal equipment services	**3,669**	3,524	3,349
Sale of equipment to subscribers	**711**	617	723
	4,380	4,141	4,072
International communications, internet and network end point services	**1,226**	1,219	1,011
Multi-channel television	**1,331**	1,284	1,171
Others	**19**	19	15
	12,400	12,232	11,925

NOTE 22 – SALARIES

	For the year ended December 31		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Salaries and related expenses –			
Operating	**1,833**	1,784	1,809
General and administrative	**733**	727	649
Share-based payments	**-**	287	346
Total salaries and associated expenses	**2,566**	2,798	2,804
Less – Salaries attributed to investments in property, plant and equipment	**191**	212	218
	2,375	2,586	2,586

NOTE 23 – OPERATING AND GENERAL EXPENSES

	For the year ended December 31		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Cellular telephone expenses	**1,828**	1,854	1,816
General expenses	**1,187**	1,169	1,258
Materials and spare parts	**924**	923	931
Consumption of satellite services content	**426**	441	419
Building maintenance	**332**	348	367
Services and maintenance by sub-contractors	**381**	428	423
International communication expenses	**338**	384	277
Motor vehicle maintenance expenses	**183**	190	181
Royalties to the Government of Israel	**194**	180	257
Collection fees	**48**	50	49
	5,841	5,967	5,978

NOTE 24 – OTHER OPERATING EXPENSES (INCOME), NET

	For the year ended December 31		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Provision (cancellation of provision) in respect of severance pay in early retirement	**91**	309	(83)
Net capital gains mostly from realisation of real estate	**(105)**	(159)	(9)
Provision in respect of contingent liabilities	**80**	97	-
Provision in respect of impairment of long-term loans	**17**	-	-
Others	**(4)**	3	(8)
	79	250	(100)

NOTE 25 – FINANCING EXPENSES, NET[1]

	For the year ended December 31,		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Interest income from bank deposits, investments and others	**116**	195	158
Net change in the fair value of financial assets measured at fair value through profit and loss (mainly for forward transactions)	**168**	-	-
Income in respect of borrowing grossed up in sales net of discount commission	**63**	49	44
Interest income and dividend from financial assets available for sale and from embedded derivatives	**6**	30	9
Net profit from the realisation of financial assets available for sale transferred from equity			
Income from financial liabilities provided by the minority in a subsidiary	**-**	5	104[2]
Net gain in respect of exchange rate differences	**96**	-	-
Other financing income	**-**	-	82
	38	77	36
	487	356	433
Interest expenses in respect of financial liabilities	**420**	477	494
Net loss in respect of linkage differentials	**193**	6	127
Net loss in respect of exchange rate differences	**114**	12	
Net change in the fair value of financial assets measured at fair value through profit and loss	**-**	103	128
Expenses in respect of capitalisation of loans to the minority in a subsidiary	**23**	50	**-**
Expenses in respect of available-for-sale financial assets	**10**	**-**	**-**
Other financing expenses	**36**	46	56
	796	694	805
Financing expenses, net	**309**	338	372
[1] Net of amounts capitalised in the amount of	**2**	1	8
Presented directly in equity			
Net change in fair value of financial assets classified as available for sale	**4**	(1)	1
Net change in the fair value of financial assets classified available for sale transferred to profit and loss	**-**	(5)	(105)

[2] The Company held 0.7405% in the satellite corporation Intelsat. On November 17, 2004, Intelsat gave notice confirming the intention to sell the corporation. The Company's share in the consideration was approximately NIS 104 million. A capital gain in the full amount was recorded in 2005.

NOTE 26 – SHARE-BASED PAYMENTS

A Following the offer for sale to the public in a prospectus of the Company and the State dated May 24, 2004, and the closing of the sale of the controlling interest in the Company from the State to Ap.Sb.Ar on October 11, 2005, the Company's employees are entitled to compensation for these sales by means of the grant of 4.71% of the shares of the Company which are held by the State. Allocation of the shares was by means of a stock options plan in accordance with an outline published by the Company on November 15, 2005.

B. Following the agreement signed with the employees (see Note 16H) in the matter of an employee stock options plan comprising 3% of the issued and paid up capital of the Company, the Board of Directors of the Company approved the employee stock options plan on February 22, 2007. On March 25, 2007, approximately 78,092,000 options were allocated, and on January 2, 2008 an additional 59,000 options were allocated to two employee-directors. The expenses for this grant were recorded in 2006, since the promise was made to the employees that year, with the terms of the grant. The value of the grant was determined at February 22, 2007, which was the date of the grant.

C. On November 20, 2007, the Board of Directors of the Company resolved to adopt a new stock options plan for managers and senior employees in the Company and/or in controlled companies, which would allocate up to 65,000,000 non-negotiable option warrants, exercisable for up to 65,000,000 shares of the Company and constituting approximately 2.5% of the issued capital of the Company, and at full dilution – 2.36% of the share capital.

On December 25, 2007, the Company published an outline for the allocation of stock options from the plan, in accordance with the Securities (Details of an outline offer of securities to employees) Regulations, 5760-2000, which described, *inter alia*, the terms of the plan, and a private placement report in accordance with the Securities (Private placement of securities in a listed company) Regulations, 5760-2000.

The options plan and the allocation of all the options in accordance with 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 in contingent upon receipt of the necessary approvals as prescribed in the provisions of the Communications (Telecommunications and broadcasts) (Determination of an essential service provided by Bezeq, The Israel Telecommunication Corp. Ltd.) Order, 5757-1997 ("the Telecommunications Order") or upon finding another solution which enables the allocation of Company shares while complying with the provisions of the Telecommunications Order, and it could be that such exercise will necessitate amendment of the Telecommunications Order.

The option warrants 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 after the date of the grant, respectively, and the expense for each portion will be spread according to its vesting period.

The exercise price of each option is NIS 5.50, which reflects a discount of approximately 16.8% on the closing price of the Company's share on the Tel Aviv Stock Exchange on January 31, 2008, the date of the approval by the general meeting.

The theoretical economic value of all the option warrants in the plan, based on a weighted Black and Scholes model, is approximately NIS 187 million, while the theoretical economic value of all the options approved and/or allocated (45,700,000 options), is approximately NIS 134 million, based, *inter alia*, on the share price on the date of grant (for options approved and/or allocated) and the share price close to the date of approval of the financial statements (for options not yet approved or allocated), a risk-free annual interest rate of 5.11% - 5.24%, the exercise price noted above, and an annual standard deviation of 22.35% - 24.20%, as well as the limitation described above pursuant to the Telecommunications Order. The Company has not yet decided on the exercise price of future option allocations, if any, under the plan. The date of the grant was set as the later of the date of the general meeting and the date of the notice to the employees.

The terms of the grants are as shown below (all the options are settled by way of physically handing over the shares):

NOTE 26 – SHARE-BASED PAYMENTS (CONTD.)

C. (contd.)

	Date of grant / Eligible employees	No. of instruments in thousands	Vesting terms	Contractual duration of the options
A.	Grant of options from the State to employees on October 11, 2005	122,698	Immediate (subject to lock-up – commencing at the end of two years, to three years – one third each year)	4 years
B.	Grant of options to employees on February 22, 2007[(1)]	78,151	Immediate (subject to lock-up for two years)	5 years
C	Approval and/or grant of options to managers, senior employees and officers by the date of approval of the financial statements	45,700	Three equal annual portions	8 years
	Total options for shares	246,549		

(1) Including 59,000 thousand options to two employee-directors, as noted in sub-section b. above.

The number and the weighted average of the exercise price of the stock options are as follows:

	No. of options (In thousands) 2007	No. of options (In thousands) 2006	No. of options (In thousands) 2005
Balance at January 1	**200,849**	122,698	122,698
Options granted during the period	**-**	78,151	-
Options for exercise at December 31	**200,849**	200,849	122,698

Subsequent to the balance sheet date, approximately 16,929,000 of the options granted by the State to employees on October 11, 2005, were exercised

The weighted average of the exercise price in 2007 and 2006 is NIS 2.852 per share and NIS 3.494 per share, respectively.

For the balance of the options issued at December 31, 2007, the exercise price is in the range of NIS 2.417 to NIS 3.013, and the weighted average of the remaining contractual life is 2.8 years.

The fair value of the services received in consideration of the stock options granted, is based on the fair value of the granted options, measured on the Black and Scholes model, based on the following parameters:

Fair value of the options and the assumptions

	2007	2006	2005
Fair value at the time of grant	-	3.653	2.817
Share price	-	6.678	6.400
Exercise price	-	3.339	4.037
Anticipated volatility (weighted average)	-	21.00%	25.25%
Useful life of the option (projected weighted average)	-	3.00	3.39
Risk-free interest rate (based on government bonds)	-	3.20%	2.45%

NOTE 26 – SHARE-BASED PAYMENTS (CONTD.)

C. (contd.)

Salary expense

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Share options granted in 2005	-	-	346
Share options granted in 2006	-	287	-
Total expenses charged to salary expenses	-	287	346

D. (1) The employment agreement of DBS with a number of senior employees provides that if DBS adopts an employee stock options plan in which employees will be granted a right to purchase shares of DBS, the plan will include those employees. The exact number of options each employee will receive in the plan will be determined at the exclusive discretion of the Management of DBS. At the date of signing the financial statements, DBS has not adopted an employee stock options plan, and therefore, no options have been allocated.

(2) Under the employment agreements of DBS with a number of senior employees, DBS undertook to grant each such employee options warrants whereby each of them will be entitled to purchase from DBS, by way of an allocation of ordinary shares of NIS 1 each, in consideration of their par value, so that after exercise of the option warrants, the number of shares that will be held by any one employee will be approximately 0.2% of the issued share capital of DBS, based on the issued capital on the date of signing the employment agreement with that employee, and noting certain safeguards against dilution which are included in some of those agreements. Each employee may exercise the option warrants for shares in accordance with the terms provided in the agreement with him. These options have not yet been granted. The allocation requires the approval of the board of directors of DBS and of the banks. In view of the aforesaid, the provisions of IFRS 2 were not applied on the matter of equity grants to employees.

(3) Under the employment agreement of the CEO of DBS, DBS undertook to allocate to him options exercisable for ordinary shares of NIS 1. The options will be allocated free of charge, and will be exercisable free of charge, for shares comprising, on the date of the agreement, 0.5% of the issued share capital of DBS.

The entitlement of the CEO of DBS to shares will be established gradually, throughout the period of his employment at DBS. At the date of approval of these financial statements, these options have not been allocated. The allocation requires the approval of the board of directors of DBS and of the banks. In view of the aforesaid, the provisions of IFRS 2 were not applied on the matter of equity grants to employees.

NOTE 27 – EARNINGS PER SHARE

Basic earnings per share

Calculation of the basic earnings per share at December 31, 2007 was based on the earnings relating to the ordinary shareholders, of NIS 1.363 million (2006 – NIS 809 million), and on a weighted average number of ordinary shares in circulation of 2,605,046,000 shares, as follows:

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Profit attributable to the ordinary shareholders			
Profit attributable to the ordinary shares	**1,330**	809	666
Weighted average of the number of ordinary shares			
Weighted average of the number of ordinary shares	**2,605**	2,605	2,605

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NOTE 27 – EARNINGS PER SHARE (CONTD.)

Diluted earnings per share
Calculation of the diluted earnings per share at December 31, 2007 was based on the earnings relating to the ordinary shareholders, of NIS 1,330 million, and on a weighted average number of ordinary shares in circulation of 2,641 million shares, as follows:

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Profit attributable to the ordinary shareholders (diluted)			
Profit attributable to the ordinary shares (basic and diluted)	**1,330**	809	666
Weighted average of the number of ordinary shares			
Weighted average of the number of ordinary shares (basic)	**2,065**	2,065	2,065
Effect of the options on the shares	**36**	-	-
Weighted average of the number of ordinary shares (diluted)	**2,641**	2,605	2,605

The average market value of the Company's shares, for calculating the diluting effect of the options on the shares, was based on the market prices in the period during which the options were in circulation.

NOTE 28 – SEGMENT REPORTING

The Group operates in various segments in the communications sector, so that every company in the Group operates in a separate business segment. The primary reporting format, by business segments, is based on the Group's management and internal reporting structure.

Each company provides services in the segment in which it operates, using the property, plant and equipment and the infrastructure it owns. The infrastructure of each company is used only for providing its services. Each of the companies in the Group is exposed to different risks and yield expectations, mainly in the matter of the technology and the competition in the segment in which it operates,

Accordingly, the separating component in the Bezeq Group which provides a service or a group of related services, and which is exposed to different risks and yield expectations than those of other segments, is every company in the Group.

Based on the above, the business segments of the Group are as follows:

- Bezeq, The Israel Telecommunication Corp. Ltd. – fixed line domestic communications.
- Pelephone Communications Ltd. – cellular communications.
- Bezeq International Ltd. – international communications, internet services and network end point.
- D.B.S. Satellite Services (1998) Ltd. – multi-channel television.

The other companies in the Group are presented under the "Other" item.

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 a segment, as well as those that can be allocated on a reasonable basis. Unallocated items comprise mainly investments (excluding real estate for investment) and the income from them, loans and borrowings and their related expenses, corporate assets and expenses of the Group, and assets and liabilities for taxes.

Segment capital expenditure is the total cost incurred during the period to acquire property, plant and equipment and intangible assets which are not goodwill.

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation

	Year ended December 31, 2007						
	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							
Revenues from external sources	5,373	4,380	1,226	1,402	19	-	12,400
Inter-segment revenues	340	304	78	12	46	(780)	-
Total revenue	5,713	4,684	1,304	1,414	65	(780)	12,400
Segment results	1,279	804	203	50	-	-	2,336
Financing costs, net							(309)
Profit after financing expenses							2,027
Equity in profits of associates accounted by the equity method							6
Profit before income tax							2,033
Income tax							672
Net profit							1,361
Attributed to:							
Shareholders of the Company							1,330
Minority interest							31
Profit for the year							1,361

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2007						
	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
Segment assets	7,769	4,290	628	1,097	59	229	14,072
Investments in associates accounted by the equity method							37
Unallocated assets							1,047
Total assets							15,156
Segment liabilities	1,944	798	321	589	37	229	3,918
Unallocated liabilities							7,066
Total liabilities							10,984
Capital expenses	520	440	69	299	3		
Depreciation	789	398	47	245	2		
Amortisation of intangible assets	136	81	25	26	2		

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2006						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Revenue							
Revenue from external sources	5,514*	4,141*	1,219*	1,339	19*	-	12,232
Inter-segment revenues	285*	337*	82*	23	37*	(764)	-
Total revenue	5,799	4,478	1,301*	1,362	56*	(764)	12,232
Segment results	746	692	119*	8	-*	-	1,565
Financing costs, net							(338)
Profit after financing expenses							1,227
Equity in profits of associates accounted by the equity method							11
Earnings before income tax							1,238
Income tax							488
Net profit							750
Attributed to:							
Shareholders of the Company							809
Minority interest in a consolidated company							(59)
Profit for the year							750

* See Note 3T.

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2006						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Segment assets	9,837*	3,717*	631*	1,008*	47*	214*	15,454
Investment in associates accounted by the equity method							32
Unallocated assets							2,059
Total assets							17,545
Segment liabilities	2,320	756	346*	584	33*	209	4,248
Unallocated liabilities							8,106
Total liabilities							12,354
Capital expenses	511	337	47*	208	2*		
Depreciation	875	407	38*	268	3*		
Amortisation of intangible assets	128	63	29*	25	3*		
Losses from impairment of intangible assets and property, plant and equipment	5	-	-	-	1		
Share-based payments	287	-	-	-	-		

* See Note 3T.

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Revenue							
Revenues from external sources	5,626*	4,072*	1,011*	1,201	15*	-	11,925
Inter-segment revenues	267*	356*	85*	21	40*	(769)	-
Total revenue	5,893	4,428	1,096*	1,222	55*	(769)	11,925
Segment results	919	585	110*	(78)	(9)*	-	1,527
Financing costs, net							(372)
Profit after financing expenses							1,155
Equity in losses of associates accounted by the equity method							(3)
Profit before income tax							1,152
Income tax							532
Net profit							620
Attributed to:							
Shareholders of the Company							666
Minority interest							(46)
Profit for the year							620

* See Note 3T.

NOTE 28 – SEGMENT REPORTING (CONTD.)

A. Segments of operation (contd.)

	Year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Segment assets	9,639	3,930*	708*	1,096*	59*	198	15,630
Investment in associates accounted by the equity method							20
Unallocated assets							3,738
Total assets							19,388
Segment liabilities	2,325	741	312*	592	46*	187	4,203
Unallocated liabilities							9,130
Total liabilities							13,333
Capital expenses	764	504	49*	266	3*		
Depreciation	971	380	52*	258	5*		
Amortisation of intangible assets	131	58	24*	26	2*		
Share-based payments	346	-	-	-	-		

* See Note 3T.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. The Company and its subsidiaries provide a range of communication services, such as telephony, access, information and data communication, transmission, satellite and video, infrastructure, international communications and internet, multi-channel television, cellular, network end point, and others ("the Services").

Among the entities for which the Company and its subsidiaries provide the Services, there are also interested parties in the Company, including Ap.Sb.Ar. which holds 30% of the Company's shares, the State of Israel, which holds approximately 16% of the Company's shares, and the Zeevi group, which holds 17.75% of the Company's shares through a receiver appointed for those shares on behalf of certain banks.

In view of the above, as far as interested parties in the Company are concerned, which are not the State of Israel, the Services provided to them by the Company and its subsidiaries are negligible transactions, and accordingly, in accordance with Article 64(3)(d)(1) of the Securities (Preparing annual financial statements) Regulations, 5753-1993 ("the Regulations"), they are not described in these financial statements.

With regard to the State of Israel as an interested party in the Company – prior to amendment of the Regulations Securities Regulations (Preparing annual financial statements) (Amendment), 5766-2005, since the description of transactions in connection with regular provision of the Services involved many difficulties (these were a range of services to the State and its many branches, including Government ministries, state companies, and government authorities and companies), the Company was exempted from describing them. Now, in view of the aforesaid amendment to the Regulations, a general description is provided of the transactions, their characteristics and scope, in accordance with Article 64(3)(d)(2) of the Regulations.

(1) The services involved are the Services defined above.

(2) The consideration for most of the transactions which the Company has with State authorities are paid at tariffs set in the Regulations. The other transactions carried out by the Company with the State, (i.e. those for which the consideration is not paid at those tariffs), such as for services for which the regulations do not set a tariff, custom-ordered work, contract work, excavation and installation, and maintenance of transmitters, as well as transactions carried out by the Company's subsidiaries with the State authorities – all these are transactions are conducted in the normal course of business at market prices, and where each individual transaction or service, of itself, is not material for the Company.

(3) For details of the transactions with government ministries, see section E below.

Arrangements which are not in compliance with these terms are disclosed separately in the financial statements.

B. Most of the Companies in the Group are required to pay royalties to the Government of Israel. Commencing January 2001, the income base requiring the payment of royalties was broadened, concurrently with a gradual reduction in the rate of the royalties, until a uniform rate was arrived at for all communications operators. In August 2006, an amendment to the royalties regulations was published, which regulates the reduction of 0.5% per year in their rate for all the licensees required to pay them, commencing January 1, 2006, until a rate of 1% per year is reached in 2010. The Ministry of Communications also gave notice that it will work for amendment of the regulations so that the Company will be exempted retroactively, from January 2004, from the duty to pay royalties in respect of revenues from services which have been opened to competition. On December 31, 2007, the Ministers of Finance and Communications submitted a draft amendment of the regulations to the Knesset Finance Committee.

In the matter of the dispute between the Company and the Ministry of Communications relating to royalties in respect of revenues from interconnect from cellular subscribers to Company subscribers, the Company reached agreement with the Ministry to end past disputes relating to royalties up to and including 2002, except for two negligible revenue components. Under this agreement, the Company paid approximately NIS 17 million to the Ministry of Communications. In the past, the Company's financial statements included a provision for royalties, which, in light of the agreement with the Ministry of Communications, is over-provided. Accordingly, expenses for royalties to the Government of Israel were reduced in 2006 by approximately NIS 36 million, and the financing expenses in respect of royalties were reduced by approximately NIS 31 million. A provision remains in the financial statements in respect of possible disputes commencing 2003, which the Company's Management deems appropriate.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

C. On May 8, 2005, a new commercial agreement was signed between the Company and the Ministry of Defence on behalf of the State of Israel, for the provision of communication services by the Company. The agreement was approved beforehand by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and required, since the Company was at that time under government control, the approval of the general meeting of the shareholders of the Company (by a special majority), as required by the Security (Transactions between a company and its controlling shareholder) Regulations, 5761-2001. Approval of the agreement was delayed at the request of the Ministry of Communications and the Antitrust Commissioner, to enable receipt of the Company's remarks on questions they had raised. On August 23, 2006, the Company received a copy of a letter from the Antitrust Authority to the legal representative of the Ministry of Defence and the IDF, in which the Authority gave notice that the agreement does not contravene the provisions of the Antitrust Law, 5748-1988, and that the Authority sees no justification, at the present time, for insisting on cancellation of the agreement. The Company forwarded a copy of the letter to the Ministry of Communications. Based on the contents of the letter, the agreement came into force and the parties operate in accordance with it. The financial statements include the income deriving from the new agreement. However, the Ministry of Communications believes that the agreement includes discounts which the Company is not authorised to grant, and that it was signed for too long a term. On March 27, 2007, the Ministry demanded (following an earlier request on December 4, 2006), that the agreement be amended so as not to violate the provisions of the law and of the Company's license. The Company has notified the Ministry of Defence of cancellation of the discount arrangements and is charging the IDF at the tariffs stated in the Agreement from July 2002, which precedes the current agreement, although the Ministry of Defence pays the Company according to the tariffs in the current agreement. At this stage the Company is unable to assess the developments and therefore the financial statements include the income from the Ministry of Defence according to the agreement dated May 8, 2005, which are lower than the tariffs in the prior agreement from 2002 and lower than the Company's regular tariffs (for the period from October 2005 to September 30, 2007).

On December 16, 2003, the Company filed a claim in the Tel Aviv District Court against the Ministry of Defence, for payment of approximately NIS 57 million in connection with a dispute on the matter of a discount of 18% which the Ministry of Defence deducted as noted above, and on March 16, 2004, the State filed its defence. On May 17, 2004, the Company filed a response. At the suggestion of the court, the parties agreed to refer the case to mediation proceedings, but subsequently decided to try to resolve their differences of opinion out of court. In April 2005, a settlement agreement was signed, which was approved by the Audit Committee of the Board of Directors and by the Board of Directors. The general meeting of the shareholders of the Company approved the agreement on June 2, 2005, as required by the Securities (Transaction between a company and its controlling shareholder) Regulations, 5761-2001. In June 2005, the settlement agreement was approved by the court and validated as a court decision.

Below are the main points of the settlement agreement:

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

(2) Arrears of one of the payments will require the Ministry of Defence to pay Accountant General's arrearage interest.

(3) Subject to the above, neither party will have any allegation and/or demand and/or claim against the other in this matter.

As a result of the settlement agreement, the Company cancelled a provision of approximately NIS 15 million.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

D. On July 29, 2007, an agreement was signed (after being approved by the general meeting of the shareholders of the Company on March 23, 2006) with a corporation owned and controlled by the shareholders of Ap.Sb.Ar., whereby the Company will be granted regular management and consultation services, including by means of currently-serving and future directors of the Company and/or its subsidiaries, all for a consideration of USD 1.2 million per year. The term of the agreement is from October 11, 2005 (the date on which Ap.Sb.Ar. purchased 30% of the shares of the Company), and ends on December 31, 2008, unless one of the parties notifies the other of its wish to terminate the agreement by giving three months' notice.

E. Transaction with interested parties and related parties

	For the year ended December 31		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Sales of products and services			
To the State of Israel	**361**	368	424
Others	**-**	3	3
Expenses			
State of Israel –			
Royalties	**194**	181	257
Frequencies	**25**	29	31
Finance	**18**	59	40
Others (mainly purchase of satellite segments)	**141**	124	116

	Interest rate	For the year ended December 31		
		2007	2006	2005
		NIS millions	NIS millions	NIS millions
Balances with related parties – Loans and long-term debts of interested parties				
Loans and debts – Index-linked, without date to maturity	0%	**1**	1	6

For other balances with related parties, see relevant notes.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

F. Benefits to directors and the CEO

	For the year ended December 31		
	2007	2006	2005
	NIS thousands	NIS thousands	NIS thousands
Total cost of salary of the CEO and the Chairman of the Board	**10,479***	13,386**	8,025***
Number of employees	**4**	2	3
Compensation for members of the Board of Directors who are not Company employees****	**372**	167	1,643
Number of directors receiving compensation	**4**	2	8
Remuneration of employee-directors*****	**996**	1,010	653
Number of directors receiving the remuneration	**2**	2	1
Management fees to a controlling company	**5,127**	5,000	1,250

* Including salary and bonuses to the serving CEO and former chairmen and to the CEO in respect of his term of office as former CEO of Bezeq International. The terms of employment of the current Chairman of the Board of Directors have not yet been agreed or approved by the relevant institutions of the Company. Nonetheless, the financial statements include a provision in the amount of approximately NIS 4.6 million based on an estimate of the cost of salary and future payments. The aforementioned cost does not include this provision, does not include salary and payments to the substitute CEO in the period from April 1, 2007 to June 26, 2007, and does not include special compensation for a former CEO of the Company, Mr. Amnon Dick, as described in Section G below.

** Includes a bonus in the amount of NIS 2.4 million to the retiring CEO. Following a request of the Securities Authority regarding senior officer bonuses, the aforementioned bonus to the CEO was cancelled. The Company decided that if this bonus is not returned to the Company it will follow legal procedures to collect the debt.

*** Includes salary and grants for the term of office of the outgoing CEO of the Company as CEO of Pelephone and also the salary and the months of notice of the CEO which preceded him, as well as salary and compensation to the Chairman of the Board of Directors who resigned during the period. The salary includes options distributed under the employee stock options plan by the State (pursuant to an outline dated November 15, 2005) to the CEO who preceded the retiring CEO and to the retiring Chairman of the Board of Directors in the period.

**** From the date of transfer of control in the Company to Ap.Sb.Ar., the directors serving on the Board of Directors of the Company, except for the external directors, do not receive compensation from the Company.

***** Salary paid to employee-directors for their work in the Company, and they receive no additional payment for their service as directors in the Company, in the matter of the options allocated to them in 2006 – see Note 26.

(1) On December 3, 2003, the general meeting of the shareholders of the Company approved an obligation to indemnify officers of the Company in the matter of the framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State pursuant to the framework agreement. The obligation was limited to NIS 890 million (the amount of capital raised), linked to the Consumer Price Index published after completion of raising the capital in accordance with the framework agreement.

(2) On May 13, 2004, the general meeting of the shareholders of the Company approved a commitment to officers in the matter of indemnity and insurance, as follows:

a. An obligation of the Company regarding the provision of a loan to officers to financing reasonable litigation expenses in legal proceedings, and an undertaking of the Company to purchase insurance policies for officers at reasonable cost.

b. Provision of indemnification notes in advance to officers of the Company in the following matters:

(1) A claim of a shareholder who held 15% or more of the share capital of the Company. The total amount of indemnity will not exceed USD 150 million, plus USD 30 million for legal expenses (a claim of this kind was excluded under the officers' insurance policies of the Company).

(2) In all matters relating to a prospectus for an offer for sale of securities of the Company by the State of Israel and an offering by the Company, which was published at the end of May 2004. The total amount of the indemnity (including undertakings to indemnify in advance which was given through publication of the prospectus and for an undertaking to indemnify in advance which will be given, if given, immediately prior to the transfer of control in the Company by the State), will not exceed 25% of the shareholders' equity of the Company (according to the 2003 financial statements, linked to the November 2003 Index).

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

F. Benefits to directors and the CEO (contd.)

(3) On April 20, 2004, the Board of Directors of the Company resolved that the Company will indemnify the employees of the Group who participated in the preparation of the prospectus that was published in May 2004, and who are not officers of the Company, for a financial liability which will be imposed upon them and for reasonable litigation expenses they would incur, regarding all matters relating to the prospectus, in the format of the indemnification letter which was given to the officers.

(4) On April 6, 2005, the general meeting of the shareholders approved an indemnification commitment in respect of a financial liability that would be imposed on officers of the Company and in respect of reasonable litigation expenses which they would incur, related directly or indirectly, to a proceeding for the sale of the State's holdings in the Company.

The indemnification commitment will be provided to officers who served and/or were appointed and/or will be appointed by the Company, commencing from the start of the Company's preparations for the sale proceeding and until the date of the closing of the sale proceeding.

The total amount of the indemnification will not exceed 25% of the shareholders' equity of the Company (according to the 2004 financial statements, linked to the November 2004 Index), including in respect of undertakings to indemnify in advance which were provided through the date of issuance of the letter of indemnification, together with an undertaking to indemnify in advance in accordance with the letter of the Minister of Finance dated April 21, 2004, which will be given, if given, immediately prior to transfer of the controlling interest in the Company by the State.

(5) On May 16, 2005, the general meeting of the shareholders approved the insurance of the officers of the Company, as follows:

Approval of the exercise of an option to purchase a run-off policy for the officers' liability to the Company, with the terms of the current policy, with the following changes:

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

b. The total amount of the insurance cover will not exceed USD 150 million, plus USD 30 million in respect of legal expenses in Israel only.

c. Limits of liability:

(1) Cover for the first 3 years at a limited liability of USD 150 million, plus USD 30 million in respect of legal expenses in Israel only.

(2) Cover for an additional 3 years at a limited liability of USD 75 million, plus USD 15 million in respect of legal expenses in Israel only.

(3) Cover for the seventh year at a limited liability of USD 25 million, plus USD 5 million in respect of legal expenses in Israel only.

It should be noted that there is one limited liability for each run-off policy.

d. The premium for the entire period of insurance – USD 3 million (in a one-time advance payment).

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

F. Benefits to directors and the CEO (contd.)

(6) The same general meeting on May 16, 2005 approved grant of an undertaking in advance to indemnify the officers of the Company who were serving with the Company at the time the indemnification commitment was provided, which will apply on the Sale Closing Date, or who served during the seven years prior to that date, due to a financial liability that would be imposed upon that person, in each of the events listed in the documents of indemnification and on the terms set out therein, where the officer acted in good faith and had reasonable grounds for assuming that the action is in the best interests of the Company. The indemnification commitment will not apply regarding an event for which an insurer acknowledged liability under an insurance policy, but if the officer was charged, due to an indemnifiable event, with a sum exceeding the amount paid to him by the insurer, the Company will indemnify him with the difference, and subject to the amount of the indemnity for all the officers in the Company not exceeding USD 150 million plus USD 30 million in respect of legal expenses in Israel only per claim, and in total for a year of insurance in the period of insurance. Upon closing the transaction of sale of the State's shares to the Ap.Sb.Ar (October 11, 2005), this undertaking comes into force.

The resolutions noted in sections 4, 5 and 6 above will be applied from the Closing Date (October 11, 2005).

(7) On August 3, 2005, the special general meeting of the shareholders of the Company approved the extension of the term of the officers' insurance policy, including a run-off option, for a period of up to 4 months, at a cost of USD 112,500 per month, commencing July 31, 2005 (the date of expiry of the prior insurance policy). Upon closing the transaction for the sale of the State's shares to Ap.Sb.Ar. (October 11, 2005), the run-off option was exercised and that policy expired.

(8) On December 26, 2007, a special general meeting of the shareholders of the Company approved the purchase of an insurance policy for the officers of the Company for a period of one year commencing October 11, 2007, with a limit of liability of up to USD 150 million per claim and in total for the entire insurance year. In addition, up to USD 30 million per claim and in total for all claims for the period of insurance, in respect of legal expenses in Israel only. The limit of liability for subsidiaries is up to USD 50 million (as part of the aforementioned limit of liability). The annual premium is up to USD 510,000.

In addition, the same meeting on December 26, 2007, approved a "framework transaction" for the Company to engage, during the normal course of business, in future insurance policies (after expiry of the present policy described above), to cover the liability of directors and officers, as may be from time to time, including directors and officers who are or might be considered controlling shareholders in the Company, all the officers in the companies in which the Company holds 50% or more, officers representing the Company in companies where the Company holds 20% or more, and senior employees who are not officers with regard to managerial actions they carry out, and all by way of a "framework transaction" as defined in the Companies (Reliefs in transactions with interested parties) Regulations, 5760-2000, at an annual premium of up to USD 510,000, plus an amount comprising 20% of that premium in respect of the amount of insurance cover existing today.

(9) On January 17, 2007, the general meeting of the Company approved making a commitment to indemnify the officers in the Company in accordance with a note of indemnity, for any liability or expense imposed on the officer due to his actions in his capacity as an officer in the Company (including his actions in subsidiaries), within the limitations provided in the Companies Law. The total amount of the indemnity was limited to a ceiling of 25% of the shareholders' equity of the Company as may be at the time of actually paying the indemnity. The note of indemnity will apply to types of events listed in an addendum to the note. Subsequently, approval was given for grant of indemnity for new officers who joined the Company.

NOTE 29 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.) (CONTD.)

G. On June 28, 2007, Ap.Sb.Ar., which holds 30% of the shares of the Company, notified the Company that it had signed an agreement with the former CEO of the Company, Mr.. Amnon Dick, whereby Ap.Sb.Ar. would pay him a special bonus of NIS 5.75 million, as a gesture in respect of his contribution to the Company. The bonus was recorded in the Company's books as a salary expense, and also in a capital fund from activities between a corporation and a controlling shareholder.

H. For guarantees to related parties, see Note 19.

NOTE 30 – FINANCIAL INSTRUMENTS

General
In the normal course of business, the Group is exposed to credit, liquidity and market risks, as well as interest, currency and Index risks. The purpose of risk management in the Group is to monitor those risks constantly, and to hedge them in order to minimise the possible effects of the exposure on the basis of assessments and expectations for parameters that generate such effects. The Group's policy is to partially hedge exposure from fluctuations in foreign exchange rates, the Index, and interest rates.

Credit risk
Credit risk is the risk of financial loss if a customer or the other part to a financial instrument fails to meet its contractual obligations, and is derived mainly from debit balances of customers and other receivables and from investments in deposits and in securities.

Management has a credit policy in place and the exposure to credit risks is monitored on a regular basis. Cash and investments in deposits and securities are deposited in highly-rated banks. Credit assessments are made on material customer balances, and collateral is required for financial assets.

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 Management's estimation, the loss inherent in debts whose collection is in question. In addition, the balances of the trade receivables are widely spread.

Investments
The Group has investments in marketable securities of the Government and of investment-grade companies, which are liquid and negotiable. 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, 2007, the Group has the guarantees described in Note 19.

At the reporting date, there is no significant concentration of credit risks. The maximum exposure to credit risk is represented by the carrying value of each financial asset, including derivatives, in the balance sheet.

Liquidity risk
Liquidity risk is the risk that the Group will be unable to honour 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 honour those obligations, in normal conditions and in conditions of distress, without incurring undesirable losses. In addition, for the matter of the debentures held by a subsidiary, see Note 13(b)(3).

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, will influence the Group's income 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, while maximising the return on the risk.
During the normal course of its business, the Group performs full or partial hedging 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 30 – FINANCIAL INSTRUMENTS (CONTD.)

Index risk
Changes in the rate of inflation affect the Group's profitability and its future cash flows, mainly due to its Index-linked liabilities. The Group has surplus liabilities over assets linked to the Index. In applying a policy of minimising the exposure, the Group makes forward transactions against the Index. The duration of the forward transactions is the same as or shorter than the duration of the hedged exposure. A considerable part of the 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 Index.

Foreign currency risk
The Group is exposed to foreign currency risks mainly due to payments for purchases of dollar-linked terminal equipment and property, plant and equipment linked o the dollar. 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 minimising the exposure, the Group makes forward transactions against the dollar. The duration of the forward transactions is the same as or shorter than the duration of the hedged exposure.

Exposure hedging
The Group has future currency contracts for hedging projected transactions. The hedging transactions made by the Group at December 31, 2007 do not meet the criteria for hedge accounting, and therefore any change in the fair value is recognised directly in profit or loss.

Interest risk
The Group is exposed to changes in the fair value of investments in debentures bearing fixed interest and of credit it receives at fixed interest. The Group is exposed to changes in its cash flows as a result of investments in debentures bearing variable interest and as a result of credit it receives at variable interest. The Group's investments in shares and amounts of interest receivable and payable in the short term, do not expose it to the same interest rate risk.

Exposure to credit risk

The carrying value of financial assets represents the maximum exposure to credit risk. The maximum exposure to credit risk as at the reporting date is:

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
	Carrying value	Carrying value
Cash and cash equivalents	**1,203**	2,632
Financial assets available for sale	**115**	121
Financial assets measured at fair value through profit and loss	**294**	894
Structured instruments	**-**	61
Trade and other receivables	**3,105**	2,685
Bank deposit for provision of loans to employees	**149**	185
Long-term loans and debit balances	**-**	36
Other investments	**3**	3
Derivatives	**61**	3

See Note 7 for the matter of maximum exposure to credit risk in respect of trade receivables.

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Liquidity risk

Below are the contractual repayment dates of monetary liabilities, including interest payments:

	At December 31, 2007						
	Carrying value	Contractual cash flow	6 months or less	6-12 months	1-2 years	3-5 years	Over five years
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Financial liabilities that are not derivatives:							
Short-term borrowings	81	81	-	81	-	-	-
Bank loans(1)	1,298	1,579	120	102	174	1,037	146
Debentures issued to the public	2,959	3,551	461	-	446	1,445	1,199
Debentures issued to financial and other institutions (2)	2,302	2,920	348	117	489	1,007	959
Institutional loans	136	254	-	-	-	-	254
	6,776	8,385	929	300	1,109	3,489	2,558
(1) Derivative financial liabilities							
Forward contracts on currencies	11	11	11	-	-	-	-
Forward contracts on the Index	-*	1	-	1	-	-	-
	11	12	11	1	-	-	-
Loans provided by the minority in a subsidiary	375	1,384	-	-	-	-	1,384

* Less than NIS 500,000.

(1) Including loans of a subsidiary amounting to approximately NIS 846 million, stated in the financial statements as short term due to non-compliance with financial stipulations (see Note 13C(3)).
(2) Including approximately NIS 112 million of debentures of the Company presented in the financial statements as short term due to non-compliance with financial stipulations (see Note 13C(1)).

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Liquidity risk (contd.)

	At December 31, 2006						
	Carrying value	Contractual cash flow	6 months or less	6-12 months	1-2 years	3-5 years	Over five years
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Financial liabilities that are not derivatives:							
Short-term borrowings	118	118	20	98	-	-	-
Bank loans(1)	2,007	2,459	258	220	374	1,065	542
Debentures issued to the public	3,333	3,799	83	1,736	390	1,157	433
Debentures issued to financial and other institutions (2)	1,830	2,193	144	135	465	934	515
Institutional loans	169	329	2	2	4	12	309
	7,457	8,898	507	2,191	1,233	3,168	1,799
(1) Derivative financial liabilities							
Forward contracts on currencies	41	38	5	1	-	32	-
Forward contracts on the Index	18	40	-	8	-	32	-
	59	78	5	9	-	64	-
Loans provided by the minority in a subsidiary	564	1,231	-	-	-	-	1,231

(1) Including loans of a subsidiary amounting to approximately NIS 1,296 million, stated in the financial statements as short term due to non-compliance with financial stipulations (see Note 13C(3)).
(2) Including approximately NIS 154 million of debentures of the Company presented in the financial statements as short term due to non-compliance with financial stipulations (see Note 13C(1)).

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Currency risks

The Group's currency risk based on denominated values is as follows:

	December 31, 2007					
	Unlinked	Index-linked	In dollars or dollar-linked	In euro or euro-linked	Other foreign currency or linked to other foreign currency	Total financial balances
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Assets						
Cash and cash equivalents	1,115	-	83	4	1	1,203
Trade receivables	2,330	15	58	-*	-	2,403
Other receivables	166	-	1	-	-	166
Other investments including derivatives	116	192	35	56	1	400
Long-term trade and other receivables	487	24	25	-	-	536
Long-term investments and loans including derivatives	149	16	-	-	-	165
Total assets	4,362	247	202	60	2	4,873
Liabilities						
Loans and borrowings	927	955	-	31	-	1,913
Trade payables	1,212	-	313	8	-	1,533
Other current liabilities and provisions	937	244	12	1	-	1,194
Long-term liabilities to banks and debentures	-	4,733	-	-	-	4,733
Loans provided by the minority and others	-	511	-	-	-	511
Other long-term current liabilities and provisions	57	28	1	-	-	86
Total liabilities	3,133	6,471	326	40	-	9,970
Details of currency futures transactions						
Dollar/shekel forward transactions	(389)	-	389	-	-	-
Index-linked shekel / shekel forward transactions	(2,600)	2,600	-	-	-	-
	(2,989)	2,600	389	-	-	-

* Less than NIS 500,000.

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Currency risks (contd.)

	December 31, 2006					
	Unlinked	Index-linked	In dollars or dollar-linked	In euro or euro-linked	Other foreign currency or linked to other foreign currency	Total financial balances
	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions	NIS millions
Assets						
Cash and cash equivalents	2,579	-	48	4	-	2,632
Trade receivables	1,990	13	55	7	-	2,065
Other receivables	153	4	-	-	-	157
Other investments including derivatives	329	490	123	30	-	972
Long-term trade and other receivables	434	24	5	-	-	463
Long-term investments and loans including derivatives	260	36	8	38	-	342
Total assets	5,745	567	239	80	-	6,631
Liabilities						
Loans and borrowings	766	1,242	-	1,629	-	3,637
Trade payables	992	-	381	20	-	1,393
Proposed dividend	300	-	-	-	-	300
Other current liabilities and provisions	825	284	3	76	-	1,188
Long-term liabilities to banks and debentures	-	3,628	-	30	-	3,658
Loans provided by the minority and others	-	733	-	-	-	733
Other long-term current liabilities and provisions	52	19	-	-	-	71
Total liabilities	2,935	5,906	384	1,755	-	10,980
Details of currency futures transactions						
Euro/shekel forward transactions	(1,574)	-	-	1,574	-	-
Dollar/shekel forward transactions	(484)	-	484			
Index-linked shekel / shekel forward transactions	(350)	350	-	-	-	-
	(2,408)	350	484	1,574	-	-

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Data in NIS for exchange rates and the Index:

	December 31 2007	December 31 2006	December 31 2005	% of change December 31 2007	% of change December 31 2006
Consumer price index in points(*)	**120.9**	116.9	117.0	**3.40**	(0.09)
1 US dollar	**3.846**	4.225	4.603	**(8.97)**	(8.21)
1 euro	**5.659**	5.564	5.447	**1.71**	2.16

(*) Index for the month at average base of 100=1998.

Sensitivity analysis for changes in the Index and foreign currency

Strengthening of the NIS against the following currencies at December 31, would increase (decrease) the shareholders' equity and the profit or loss by the amounts shown below. The analysis is made on the assumption that all other variables, and in particular the interest rates, would remain fixed. The analysis for 2006 was made on the same basis.

	Equity NIS millions	Profit or loss NIS millions
December 31, 2007		
USD1 – 10% strengthening of the shekel vis-à-vis the dollar	17	17
Euro 1 – 5% strengthening of the shekel vis-à-vis the euro	1	(1)
Index – 5% strengthening beyond the inflation forecast (inflation forecast of 2% per year)	(2)	(2)
December 31, 2006		
USD1 – 10% strengthening of the shekel vis-à-vis the dollar	6	6
Euro 1 – 5% strengthening of the shekel vis-à-vis the euro	(3)	(4)
Index – 5% strengthening according to an inflation forecast of 2% per year	(3)	(3)

Weakening of the NIS against the above currencies at December 31, would have the same effect in the opposite direction and in the same amounts, assuming all other variables remain fixed.

Interest rate risks

The interest rate profile of the Group's interest-bearing financial instruments at the reporting date is as follows:

	Carrying value 2007 NIS millions	Carrying value 2006 NIS millions
Fixed-interest instruments		
Financial assets	**2,514**	3,783*
Financial liabilities	**(5,818)**	(6,660)
Loans provided by the minority in a subsidiary	**(375)**	(564)
Variable-interest instruments	**(3,679)**	(3,441)
Financial assets	**23**	103*
Financial liabilities	**(958)**	(797)
	(935)	(694)

* See Note 3T.

Sensitivity analysis of the fair value for instruments at fixed interest

The Group's assets and liabilities at fixed interest are not measured at fair value through profit and loss, nor does the Group earmark derivatives (interest swap contracts) as hedging instruments according to a hedge accounting model of fair value. Therefore, a change in interest rates at the reporting date will not affect profit and loss.

NOTE 30 – FINANCIAL INSTRUMENTS (CONTD.)

Sensitivity analysis of cash flows for instruments at variable interest

A rise of 100 base points in the interest rates at the reporting date would reduce the shareholders' equity and the profit or loss by approximately NIS 7 million (2006 – NIS 5 million). The analysis was made assuming all other variables, and in particular the foreign currency exchange rates, would remain fixed.

Fair value

The table below details the differences between the carrying value and the fair value of groups of financial instruments, where material differences exist. The carrying value of financial assets does not differ significantly from their fair value. The fair value of long-term loans provided by the minority in a subsidiary is similar to the carrying value in the books.

		December 31, 2007		December 31, 2006	
		Carrying value	Fair value	Carrying value	Fair value
	Note	NIS millions	NIS millions	NIS millions	NIS millions
Loan provided	6	**-**	**-**	22	25
Investment in capital notes	6	**-**	**-**	16	16
		-	**-**	38	41
Unrecognised profit			**-**		3
Short-term borrowing	13	**81**	**81**	118	118
Secured loans from banks and others	13				
Index-linked		**588**	**598**	1,528	1,451
Unlinked		**846**	**846**	648	648
Debentures issued to the public	13				
Index-linked		**2,959**	**3,046**	1,704	1,762
Denominated in euro		**-**	**-**	1,629	1,691
Debentures issued to financial institutions and others					
Index-linked	13	**2,271**	**2,354**	1,799	1,829
Euro-linked		**31**	**31**	31	33
		6,776	**6,956**	7,457	7,532
Unrecognised loss			**180**		75

Estimation of fair values

The methods used to estimate the fair values of financial instruments are described in Note 4.

Interest rates applied in the determination of fair value

	2007	2006
	%	%
Long-term trade receivables	**7.2**	7.6
Loans and receivables	**-**	5.6
Loans	**5.5**	6.4
Debentures	**5.3**	4.4

NOTE 31 – DETAILS OF OTHER MOVEMENTS IN EQUITY

	Share capital	Share premium	Capital reserve in respect of activities between a corporation and a controlling shareholder	Capital reserve in respect of available-for-sale financial assets	Capital reserve in respect of employee options	Deficit	Total	Minority interest	Total equity
	NIS millions								
	Related to shareholders of the Company								
Balance at January 1, 2007	**6,309**	**1,623**	**384**	**1**	**287**	**(2,849)**	**5,755**	**(564)**	**5,191**
Total recognised income and expense	**-**	**-**	**-**	**3**	**-**	**1,341**	**1,344**	**31**	**1,375**
Dividends to equity holders	**-**	**-**	**-**	**-**	**-**	**(760)**	**(760)**	**-**	**(760)**
Dividends to equity holders – distribution that does not pass the earnings test	**(177)**	**(1,623)**	**-**	**-**	**-**	**-**	**(1,800)**	**-**	**(1,800)**
Change in the repayment date of a loan provided by the minority in a subsidiary	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**160**	**160**
Payments to a former senior officer	**-**	**-**	**6**	**-**	**-**	**-**	**6**	**-**	**6**
Balance at December 31, 2007	**6,132**	**-**	**390**	**4**	**287**	**(2,268)**	**4,545**	**(373)**	**4,172**

NOTE 31 – DETAILS OF OTHER MOVEMENTS IN EQUITY (CONTD.)

	Share capital	Share premium	Capital reserve in respect of activities between a corporation and a controlling shareholder	Capital reserve in respect of available-for -sale financial assets	Capital reserve in respect of employee options	Deficit	Total	Minority interest	Total equity
	NIS millions								
	Related to shareholders of the Company								
Balance at January 1, 2006	6,309	1,623	384	6	-	(1,762)	6,560	(505)	6,055
Total recognised income and expense	-	-	-	(5)	-	813	808	(59)	749
Dividends to equity holders of the Company	-					(1,900)	(1,900)	-	(1,900)
Share-based payments made by the Company	-	-	-	-	287	-	287	-	287
Balance at December 31, 2006	6,309	1,623	384	1	287	(2,849)	5,755	(564)	5,191

NOTE 31 – DETAILS OF OTHER MOVEMENTS IN EQUITY (CONTD.)

	Share capital	Share premium	Capital reserve in respect of activities between a corporation and a controlling shareholder	Capital reserve in respect of available-for-sale financial assets	Deficit	Total	Minority interest	Total equity
	NIS millions							
	Related to shareholders of the Company							
Balance at January 1, 2005	6,309	1,623	37	73	(2,417)	5,625	(467)	5,158
Total recognised income and expense	-	-	-	(67)	655	588	(46)	542
Payment from the State to employees in respect of privatisation of the Company	-	-	1	-	-	1	-	1
Share-based payments to Company employees from its equity holders	-	-	346	-	-	346	-	346
Minority interest in a benefit deriving from a change in the terms of equity holder loans	-	-	-	-	-	-	8	8
Balance at December 31, 2005	6,309	1,623	384	6	(1,762)	6,560	(505)	6,055

* Less than NIS 500,000

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NOTE 32 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY

Balance sheet

	2007	2006
	NIS millions	NIS millions
Assets		
Cash and cash equivalents	**451**	2,262
Other investments, including derivatives	**366**	957
Trade receivables	**1,059**	857
Other receivables	**181**	214
Inventory	**19**	13
Assets classified as held for sale	**17**	-
Total current assets	**2,093**	4,303
Trade and other payables	**51**	80
Investments and loans, including derivatives	**174**	276
Property, plant and equipment	**3,873**	4,245
Intangible assets	**176**	230
Deferred and other expenses	**185**	221
Investments in associates accounted by the cost method	**5,033**	5,973
Deferred tax assets	**643**	739
Total non-current assets	**10,135**	11,764
Total assets	**12,228**	16,067

NOTE 32 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

Balance sheet (contd.)

	2007	2006
	NIS millions	NIS millions
Liabilities		
Loans and borrowings	**722**	1,877
Trade payables	**448**	394
Other payables, including derivatives	**490**	578
Current tax liabilities	**57**	78
Deferred income	**21**	27
Provisions	**287**	208
Employee benefits	**663**	863
Proposed dividend	**-**	300
Total current liabilities	**2,688**	4,325
Debentures	**3,974**	4,381
Other long-term liabilities	**7**	27
Employee benefits	**219**	336
Total non-current liabilities	**4,200**	4,744
Total liabilities	**6,888**	9,069
Equity		
Share capital	**6,132**	6,309
Share premium	**-**	1,623
Reserves	**680**	670
Capital deficit	**(1,472)**	(1,604)
Total equity	**5,340**	6,998
Total equity and liabilities	**12,228**	16,067

NOTE 32 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. Statement of income

	For the year ended December 31		
	2007	**2006**	**2005**
	NIS millions	**NIS millions**	**NIS millions**
Income	**5,713**	5,799	5,893
Costs and expenses			
Depreciation	**941**	1,026	1,109
Wages	**1,293**	1,557	1,571
General and operating expenses	**2,121**	2,233	2,391
Other expenses (income), net	**79**	229	(97)
	4,434	5,045	4,974
Operating profit	**1,279**	754	919
Financing expenses (income), net	**3**	(688)	36
Profit before income tax	**1,276**	1,442	883
Income tax	**394**	254	375
Profit for the year	**882**	1,188	508

Income segmentation

	For the year ended December 31		
	2007	**2006**	**2005**
	NIS millions	**NIS millions**	**NIS millions**
Telephony	**3,905**	4,148	4,337
Internet	**712**	608	550
Transmission and data communication	**754**	711	691
Other services	**342**	332	315
	5,713	5,799	5,893

NOTE 32 – CONDENSED DATA FROM THE SEPARATE FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

C. Statement of recognised income and expense for the year ended December 31

	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Net change in fair value of available-for-sale financial assets	**5**	(1)	1
Net change in fair value of available-for-sale financial assets transferred to profit or loss	**-**	(5)	(105)
Defined benefit plan actuarial gains (losses)	**13**	(3)	(16)
Income tax on income and expense recognised directly in equity	**(4)**	2	41
Income and expenses recognised directly in equity	**14**	(7)	(79)
Profit for the year	**882**	1,188	508
Total recognised income and expense	**896**	1,181	429

D. Statement of cash flows

	For the year ended December 31		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Cash flows from operating activities			
Profit	**882**	1,188	508
Adjustments to profit	**595**	1,536*	2,011*
Net cash from operating activities	**1, 477**	2,724	2,519
Cash flows from (used for) investment activities	**362**	630	(1,371)
Cash flows used for financing activities	**(3,632)**	(2,776)*	(798)*
Net increase in cash and cash equivalents	**(1,793)**	578	350
Cash and cash equivalents at January 1	**2,262**	1,679	1,328
Effect of exchange rate fluctuations on cash balances	**(18)**	5	1
Cash and cash equivalents at December 31	**451**	2,262	1,679

* See Note 3T.

NOTE 33 – GROUP ENTITIES

	Country of registration	Rate of ownership For the year ended December 31, 2007	2006
Pelephone Communications Ltd. (1)	Israel	**100**	100
Bezeq International Ltd. (2)	Israel	**100**	100
D.B.S. Satellite Services (1998) Ltd. (3)	Israel	**49.8**	49.8
BezeqCall Communications Ltd. (2)	Israel	**-**	100
Bezeq On Line Ltd. (4)	Israel	**100**	100
Bezeq Zahav (Holdings) Ltd. (5)	Israel	**100**	100
Stage One (6)	Israel	**83**	83
GoldNet Communication Services – registered partnership (2)	Israel	**-**	100

(1) Pelephone Communications Ltd.

Pelephone Communications Ltd. ("Pelephone") is a wholly-owned subsidiary of the Company. Pelephone provides cellular services, and sells and repairs terminal equipment.

Pelephone operates under an operating license from the Ministry of Communications – a general license for cellular services ("the License"). The License, in its updated form, was received on February 7, 1996 for a period of 10 years from its commencement date of January 1, 1994, with an option for extension for another 6 years ("the Additional Period") and for renewal for an additional one or more periods of 6 years beyond the Additional Period.

In the framework of winning an additional band of frequencies in December 2001, Pelephone's License was extended to 2022.

(2) Bezeq International Ltd.

Bezeq International Ltd. ("Bezeq International") is wholly-owned by the Company, and was established on April 5, 1995 to engage in international communications, in accordance with a Government decision on December 28, 1994 and following a change in the general license of the Company. Since 1999, Bezeq International has also been providing internet access services. Bezeq International has holdings in the Walla! Communications Group Ltd. (see Note 12). Following the merger with BezeqCall Communications Ltd. ("BezeqCall"),BezeqCall's network end point license was assigned to Bezeq International.

Following an agreement signed on October 15, 2006 between BezeqCall and Tadiran Telecom Communication Services Israel – Limited Partnership ("Tadiran") for the acquisition of Tadiran's operation in consideration of approximately NIS 93 million, in April 2007, the agreement for acquisition of the partnership was cancelled, in view of the decision of the Antitrust Authority not to approve the transaction and following Tadiran's notice of its decision to cancel the agreement.

In addition, on April 30, 2006, the Company and M.L.M. Systems Ltd., which are partners in Goldnet Communications Services ("Goldnet"), a registered partnership which provides solutions for secure electronic data transfer between organisations, signed an agreement with the subsidiary Bezeq International. Under the agreement, Bezeq International acquired all the operations of Goldnet.

After compliance with all the preconditions set out in the acquisition agreement, during July 2006, Goldnet, which conducted its business under the trade name Bezeq Zahav, ceased to provide services and its operation was merged with Bezeq International.

NOTE 33 – GROUP ENTITIES (CONTD.)

(3) D.B.S. Satellite Services (1998) Ltd.

D.B.S. Satellite Services (1998) Ltd. ("DBS") was incorporated in Israel on December 2, 1998. In January 1999, DBS received a license from the Ministry of Communications to transmit satellite television broadcasts in Israel ("the License"). The term of the License when granted to the consolidated company is through January 2014, and can be extended for a period of six additional years on certain terms. In its operations, DBS is subject to the Communications (Telecommunications and broadcasts) Law, 5742-1982 ("the Communications Law'), its concomitant regulations and rules, and the terms of its license.

In July 2000, DBS ended its preparation stage and began to provide its customers with multi-channel television broadcasts in accordance with the License granted pursuant to the Communications Law.

On March 31, 2004, the then Minister of Communications signed an amendment to the Company's license, which includes a provision whereby the Company is obliged to maintain complete structural separation between it and its subsidiaries, including DBS. Business cooperation between the Company and the subsidiaries, including DBS, was also prohibited, unless, *inter alia*, the competitive status of DBS deteriorates materially.
Regarding the financial position of DBS, see below.

A. (1) Since commencing operations, DBS has accumulated considerable losses. DBS's losses in 2007 and 2006 amounted to approximately NIS 118 million and NIS 320 million, respectively. As a result of these losses, its capital deficit and its working capital deficit at December 31, 2007 amount to approximately NIS 2,629 million and NIS 1,327 million respectively.

The Company's investment in DBS (primarily in shareholder loans) at the balance sheet date amount to approximately NIS 1,562 million (without interest and linkage). The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 148 million, of which approximately NIS 112 million is to the Company. The Company and DBS put together an arrangement for collection of the balance of DBS's debt to the Company which was in arrears, approximately NIS 55.6 million. Under the arrangement, the debt is being paid in 60 equal monthly instalments plus interest at prime + 1.5%. At the balance sheet date, the balance of the debt covered by the arrangement is approximately NIS 42 million. The balance of the debt to the Company outside the above arrangement, is current debt for which the agreed terms of payment are the usual credit terms between the Company and its customers. At the date of approval of the financial statements, DBS is not in compliance with the terms of the arrangement and these credit terms. The Company, as well, as its consolidated companies, are acting to collect the debts of DBS which are in arrears.

During 2005, the banks completed the provision of the entire credit facility to which DBS was entitled under the financing agreements. See Note 13C(3).

(2) On July 31, 2007, in a private placement. DBS issued approximately NIS 620 million par value of debentures (Series A) to institutional investors, to be registered in a continuous institutional system on the Tel Aviv stock exchange. The net proceeds from the issuance amounted to approximately NIS 614 million. The terms of the debentures are explained above (see Note 13B and C above).

(3) Following decisions of Ministers of Communications during 2004 and 2005, which limit injections to DBS by the Company, on February 17, 2005, the Board of Directors of the Company resolved that it stands behind its resolution of March 30, 2004 to continue investing in DBS according to the approved work plan, together with other shareholders and financing entities. This resolution was based, among others, on an external legal opinion that the Minister of Communications does not have the authority to prohibit injections of funds by the Company to DBS.

NOTE 33 – GROUP ENTITIES (CONTD.)

(3) DBS (contd.)

A. (3) (contd.)

During April and May 2005, the Company and DBS filed petitions in the High Court of Justice for an order *nisi* against the then Minister of Communications, according to which the aforementioned decisions of the Ministry of Communications are void *ab initio*. The petitions were heard on October 11, 2005 and in September 2007 the petitions were dismissed *in limine*.

(4) For DBS's non-compliance with payment arrangement with suppliers, see Note 18(c).

(5) On December 20, 2007, the board of directors of DBS approved the budget for 2008. According to this budget, in 2008 DBS will require additional external financing. At the date of approval of the financial statements, DBS is working to obtain additional finance resources that will enable it to attain the budget targets for the coming year. If those resources cannot be found, DBS will operate in accordance with an alternative business plan which does not necessitate financial resources beyond those at its disposal. The Management of DBS estimates, based on the 2008 budget and on the alternative business plan, that it is more likely than not that the financial resources it requires in the coming year can be arranged.

B. On January 2, 2005, the Antitrust Commissioner gave his approval for the merger of DBS (increasing the Company's holding in DBS beyond 50%) on certain conditions. The merger was not accomplished within a year of the date of its approval, and required renewed consent. On August 2, 2006, the Company and DBS filed new merger notices to the Antitrust Commissioner on the matter of exercise of the options for DBS shares by the Company, which are expected to increase the Company's holdings in DBS from approximately 49.8% to approximately 58%. On December 31, 2006, the Antitrust Authority announced the Commissioner's opposition to the merger, and on February 18, 2007, it gave the reasons for the opposition. On May 15, 2007, the Company appealed the decision. The Antitrust Commissioner has filed his response to the appeal and the case is ongoing.

It is noted that even though the options held by the Company in DBS have not yet been exercised for the reasons stated above, the Company consolidates DBS fully into its financial statements.

Concerning the petition of the Company and DBS to the High Court of Justice against the Minister of Communications in the matter of restrictions imposed on the Company's investments in DBS, the petition was dismissed in September 2007.

(4) Bezeq On Line Ltd.

Bezeq On Line Ltd. ("Bezeq On Line") was established in December 2000 and commenced operation in 2001, providing call centre outsourcing services.

(5) 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 and commenced operations in May 2004. Bezeq Zahav holds debentures issued by the Company.

(6) Stage One Venture Capital Fund (Israel L.P.

This is a venture capital fund in which the management rights are held by the SOCI, and the Company has rights in the profits – see Note 3A(2).

NOTE 34 – SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD.

1. Pelephone Communications Ltd.

A. Balance sheet

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
Current assets	**1,976**	1,405
Non-current assets	**2,363**	2,566
	4,339	3,971
Current liabilities	**1,106**	1,089
Long-term liabilities	**1,154**	1,384
Total liabilities	**2,260**	2,473
Shareholders' equity	**2,079**	1,498
	4,339	3,971

B. Income statement

	For the year ended December 31,		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Income from services and sales	**4,684**	4,478	4,428
Cost of services and sales	**3,347**	3,250	3,301
Gross profit	**1,337**	1,228	1,127
Sales and marketing expenses	**430**	417	428
General and administrative expenses	**102**	110	108
	532	527	536
Operating income	**805**	701	591
Financing expenses	**114**	107	200
Financing income	**(109)**	(89)	(76)
Financing costs, net	**5**	18	124
Share in losses of an affiliated partnership, net	**-**	-	8
Profit before income tax	**800**	683	459
Income tax	**215**	197	172
Profit for the year	**585**	486	287

NOTE 34 – SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. D.B.S. Satellite Services (1998) Ltd.

A. Balance sheet

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
Current assets	**400**	338
Non-current assets	**706**	678*
	1,106	1,016
Current liabilities	**1,483**	1,889
Long-term liabilities	**2,252**	1,988*
Total liabilities	**3,735**	3,877
Equity deficit	**(2,629)**	(2,861)
	1,106	1,016

B. Income statement

	For the year ended December 31,		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Income	**1,415**	1,355	1,222
Cost of income	**1,117**	1,139	1,072
Gross profit	**298**	216	150
Sales and marketing expenses	**138**	123	142
General and administrative expenses	**104**	92*	72*
	242	215	214
Operating income (loss)	**56**	1	(64)
Financing expenses	**394**	328	281
Financing income	**(226)****	(9)	(2)
Financing costs, net	**168**	319	279
Loss before income tax	**(112)**	(318)	(343)
Income tax	**6**	2*	3*
Loss for the year	**(118)**	(320)	(346)

* See Note 3T.
** See Note 13E

NOTE 34 – SELECTED CONDENSED DATA FROM THE FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. Bezeq International Ltd.**

A. Balance sheet

	December 31, 2007	December 31, 2006
	NIS millions	NIS millions
Current assets	**431**	332
Non-current assets	**456**	341
	887	673
Current liabilities	**312**	307
Long-term liabilities	**26**	16
Total liabilities	**338**	323
Shareholders' equity	**549**	350
	887	673

B. Income statement

	For the year ended December 31,		
	2007	2006	2005
	NIS millions	NIS millions	NIS millions
Income	**1,304**	1,021	815
Cost of income	**859**	662	530
Gross profit	**445**	359	285
Sales and marketing expenses	**147**	148	136
General and administrative expenses	**94**	72	57
Other income (expenses), net	**-***	7	(1)
Operating income	**204**	132	93
Financing costs, net			
Financing expenses	**13**	20	15
Financing income	**(14)**	(13)	(6)
Financing incomes (expenses), net	**(1)**	7	9
Share in profits of an associate accounted by the equity method	**6**	11	5
Profit before income tax	**211**	136	89
Income tax	**58**	40	(15)
Net profit for the year	**153**	96	104

* Less than NIS 500,000.

** The above financial statements are presented in accordance with IFRSs only, Furthermore, commencing January 1, 2007, the financial statements include the operations of BezeqCall Communications Ltd.

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Bezeq
Israel

March 9, 2008

Actuarial calculations in accordance with
International Financial Reporting Standard 19 *Employee Benefits*

Dear Sir/Madam,

You have asked us to provide a valuation of the post-employment benefit liability of Bezeq Group in accordance with IAS 19 (revised 2004), for valuation date 31st December 2007.

Considering the following obligations, we have calculated the present value of the defined benefit obligation as of the date listed above, and the current service cost for the financial year ending 31st December 2007.

Section A – Benefits

A1 - Bezeq

1) **Long Term Benefit liability**
   a) The calculations of this section of the report refer to the liability arising on utilization, redemption or realization of past-accrued benefits, but which are not necessarily a result of cessation of employment.
      i) Accrued vacation days:
         (1) Employees have accrued vacation days, which are capped at maximum accrual of 54 days for permanent employees and as per the following table for temporary employees.

Years of service	Annual accrual	Maximum Accrual
1-4	12	14
5	14	14
6	17	16
7	19	20
8	20	25
9+	21.5	29

These vacation days can be utilized throughout the employment period or redeemed at the time of leave. All employees are entitled to redeem vacation days. The redemption is always for the full number of accrued days.

(2) The cap of 54 days per employee was a change made in the December 2007 valuation, where previously the cap had been 75.5 days. Additionally, where previously excess days were assumed to be redeemed, for the December 2007 valuation any excess days above the cap are simply removed from the employees' vacation day accrual, following Bezeq's stated policy. The impact of this change was a decrease in reserve of ca. 4.5 M NIS.

(3) For vacation days, the redemption value is assumed to be the monthly salary for pension purposes divided by 20.83. The usage value reflects additional social and other costs, which are calculated on a per person basis.[1]

(4) For vacation days, negative balances were registered as asset. The assumption is that for the majority of cases, such negative balances are settled within a year of the valuation[2].

ii) Accrued sick days:

(1) All employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. For permanent employees, except "Dor 2000" and "Sechar Kollel" employees, if the sick days are not used up they can be redeemed at the time of leave (no matter what the circumstances of the leave, provided the employee is aged at least 55 on leave). The sick days for utilization are capped at 90 days for most employees (except "Sechar Kollel" and tenured employees for whom there is unlimited usage[3]), after which time some form of disability insurance becomes applicable.[4] Sick days for redemption purposes are not capped.

(2) For employees who retire under selected tracks in the early retirement plan (see 2)a)) there is partial redemption of sick days from age 50-55, whereby the redemption is at 50% for age 50 and rises with each year of age to 100% at age 55 and above.

(3) Accrual of sick days for permanent employees is 30 days per year, whilst for temporary employees it is 18 days per year.

(4) The accrued sick days, if not used by the time the employee leaves the company, maybe redeemed at their redemption value, which depends on the employee's salary at the time of leave and the level of utilization of sick days throughout his employment history. A high level of utilization entitles him to a more limited or no redemption value. The rates were altered for sick days accrued after 1st January 2007[5]. The following conversion table applies:

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1 In previous valuations, the Company used an additional 27.51% factor for all employees to reflect social benefits and other costs.

2 One could argue that a settlement horizon of a year from valuation falls into the category of short term benefits and should possibly be registered as a short term asset outside this report, which only addresses long-term, termination, and post-employment benefits. However, the judgement on whether a benefit is included in the report or not was made based on the overall benefit provided by the company and not with regard to each employee seriatim.

3 This does not currently affect the liability, see 1)a)v)(1) below.

4 As the employee accrues future sick days, the utilization will increasingly be from these days (due to the "Last In, First Out" methodology prescribed by IAS 19), until after 5 years there is no more utilization liability.

5 This change is not reflected in the current valuation due to lack of materiality.

Utilization Level		For each 30 Accrued Days	
		Days Accrued Up to 31/12/06	**Days Accrued From 1/1/07**
From	**To**		
0%	35%	8 days	7 days
36%	65%	6 days	5 days
66%	100%	0 days	0 days

(5) For sickness the redemption value for a each day is assumed to be the salary for pension purposes with the addition of the monthly "Havraah" amount, divided by 25, while the usage values is assumed to be the cost to employer each month divided by 25.

(6) No negative balances for sick days were considered in the valuation.

2) Termination Benefits

a) The calculations of this section refer to the liability that has arisen from early retirement programs, which are special programs to make the company more efficient.[6] An agreement was signed during 2006, which reflects an additional set of well-defined early retirement benefits for 675 employees (not including the full retirement track discussed below).[7] During the last quarter of 2007 an additional 38 employees were added to these 675, for a total of 713 employees[8]. The retirements fall under two tracks – a track for employees aged over 50 and with a minimum of 20 years of service (hereafter 50/20) and a track for employees aged over 45 and with a minimum of 15 years of service (hereafter 45/15):

i) Employees who have already retired under the previous early retirement scheme are not included in this report.

ii) 641 employees who have retired under the new early retirement scheme are included in the report.

iii) Scheduled Retirees: there are 66 employees who have a scheduled retirement date falling after 1st January 2008.

iv) Transferred employees:

(1) Track 50/20 – 6 future retirements in 2008.

b) The pension agreement provides two systems for determining pension rights for retirees among the transferred workers (while non-transferred employees may only select Track B):

6 For the valuation of the early retirement benefit in as of 12/2004, the basis of the valuation is the prescribed methodology and assumptions for early retirement benefit purchases through the Makefet pension funds. This methodology was anchored at the time in a letter published by the Ministry of Finance in 1999.

7 There is an additional population of employees who are entitled to retire with enhanced severance pay. However, there are no actuarial calculations needed for these employees, and the benefit is short-term, so this element is not included in our report.

8 This increase in early retirees is reflected under "Gains/losses from terminations and settlements" in all the relevant benefits, representing the addition of retirees for early retirement and the removal of employees for severance, vacation, sickness and full retirement benefits.

   i) Track A – which was determined on the basis of the assessment pension rules in the civil service, i.e. the pension will be determined on the basis of the average of the grades in the last three years prior to the retirement and updated according to the rules for civil servants. The pension in this track is linked to the cost-of-living increments and the wage agreements in the economy.
   ii) Track B – was determined on the basis of the Makefet bylaws, i.e. it sets the pension according to a relative salary average called the "averages method", taking into account the best 35 years (hereinafter: "the Averages Method"). A pension in this track is linked to the CPI on the dates on which a cost-of-living increment was given in the economy.

c) At the beginning of July 2005, an agreement was signed between Bezeq and Harel Insurance Company, whereby Bezeq makes a single payment to Harel at the time of retirement of each employee and Harel takes responsibility for the payment of the old-age and survivors pensions to the early retirees, as detailed below. Bezeq will freeze contributions to the Makefet pension fund in respect of those employees who take early retirement according to this agreement.
   i) Early retirement pension – from the date of the early retirement of the employee until their reaching the statutory retirement age (as defined in the Retirement Age Law, 5764-2004), Harel will pay the retiree a monthly pension according to the amount defined by Bezeq.
   ii) Old age pension – from the month after reaching statutory retirement age, Harel will pay a monthly pension to the retiree, whose sum is the difference between the pension set according to Bezeq and the pension being received from the Makefet Pension Fund under the standard bylaws governing the old pension funds (as defined by the Ministry of Finance).
   iii) Survivors' pension – following the death of the retiree, Harel will pay a pension equal to 60% of the old-age pension (i.e. the difference between the Bezeq and Makefet pensions) to the spouse of the retiree. Each orphan under age 21 will receive 20% of the old-age pension, up to a maximum of 100% of the basic old-age pension for the spouse and orphans combined. In the event that the 100% limit will be passed, the orphans' share (40%) will be divided equally according to the number of eligible orphans. When an orphan reaches age 21, the orphans' share is reallocated for orphans of a transferred employee, and is not reallocated for the orphans of a non-transferred employee. In the event there is no spouse, each orphan receives a double-share (viz. 40%), while the 100% limit remains in effect.
   iv) All pensions are linked to the inflation index as defined by the pension fund regulations.

d) Bezeq signed a revised version of the agreement with Harel during 2007, effective from the end of 2007. This change is reflected in the December 2007 valuation, and resulted in a decrease in liability of ca. 5 M NIS.

3) Post-employment benefit liability

a) The calculations of this section of the report refer solely to the liability arising on cessation of employment. Israeli labour laws and agreements require the company to pay severance pay to employees who reach full retirement age, who leave the company's employ under certain conditions (including termination of employment by the employer)[9], who die, or are disabled and unable to continue work. The calculation of the severance pay liability was made in accordance with labour agreement in force and based on salary components that in the management's opinion create entitlement to severance pay.

b) The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.

c) The liability for employee severance pay calculated here represents the unfunded balance of the total liability in respect of severance pay.

d) For most employees a § 14 Exemption applies. For employees with a § 14 Exemption we have calculated the liability for the period of service prior to the signing of the § 14 Exemption. The amount payable is one monthly salary for each year's employment (which is not subject to § 14 Exemption), based on the final salary prior to termination of employment[10].

e) Some employees (see exact numbers in 1)c)i) below) have no § 14 Exemption, who are included in this report.

   i) The amount payable is one monthly salary for each year's employment (which is not subject to § 14 Exemption), based on the final salary prior to termination of employment[11], net of the accrual balance in the severance pay fund.

   ii) For employees who choose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan and additionally supplements to the full severance pay amount. This forms a constructive obligation and as such is considered a liability under IAS 19.[12]

f) Full retirement for transferred employees offered as part of the 2006 early retirement agreement between Bezeq and its union. This is expected to affect a further 380 employees[13]. For these employees, Bezeq will pay the difference between the civil service linked pension and the actual pension received from Makefet to the employee from retirement for the rest of their life.

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[9] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[10] As per Bezeq's directive, the last salary as of date of termination date is used and not the last salary as of the § 14 Exemption date.

[11] See footnote 10.

[12] As such, we have assumed that all leaves are with full severance pay. See actuarial assumptions below.

[13] This represents a reduction from the 452 employees eligible for this benefit as of 31st December 2006, due to an increase in the total number of employees retiring under the early retirement scheme and also an increase in the proportion of transferred employees within the early retirement population. The combined effect of these two elements was a decrease in cost of ca. 21 M NIS, which can be seen under "Losses (gains) on curtailments".

g) Employees are also entitled to holiday gifts/bonuses, which are provided once a year to employees, retirees, and surviving spouses of retirees. The benefits valued under these guidelines, only include the benefits in respect of post-employment gifts.[14]

h) In addition, pensioners and their spouses can attend clubs, which are maintained by Bezeq.

i) Finally, there is a budget for activities each retiree and their spouse are entitled to participate in.

4) Calculation method

a) As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

b) The defined benefit obligation reflects the entitlement earned by active employees only.

c) As per IAS 19.102-4 the individual asset values have been calculated using a discounted cash flow approach.[15]

d) Full Retirement Benefit: as per IAS 19 such benefit adjustments are considered recognition of past service cost. The liability is computed using the accrued pension percent as of the introduction of this benefit to reflect the past service cost. Since the benefit is not vested[16] until full retirement, as per IAS 19.96, the past service cost is spread over the average period until the benefit becomes vested. This period is 18.75 years from December 2006, when weighting it for the past service cost. Following the change in population eligible for the benefit in 2007, as noted in 2)a) above, we have adjusted the past service cost accordingly.[17]

[14] Holiday gifts payable to employees are an on-going cost.

[15] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable. We have assumed a guaranteed real return of 2.0% p.a. for old pension funds under government control.

[16] *Vested employee benefits* are employee benefits that are not conditional on future employment.

[17] There is no change to the start date, or to the average period until vesting, which has not altered.

A2 – Bezeq Seniors

5) **Long Term Benefit liability**
   a) The calculations of this section of the report refer to the liability arising on utilization, redemption or realization of past-accrued benefits, but which are not necessarily a result of cessation of employment.
      i) Accrued vacation days:
         (1) Employees have accrued vacation days, which are capped at maximum accrual of 54 days. These vacation days can be utilized throughout the employment period or redeemed at the time of leave. All employees are entitled to redeem vacation days. The redemption is always for the full number of accrued days.
         (2) The cap of 54 days per employee was a change made in the December 2007 valuation, where previously the cap had been 75.5 days. Additionally, where previously excess days were assumed to be redeemed, for the December 2007 valuation any excess days above the cap are simply removed from the employees' vacation day accrual, following Bezeq's stated policy.
         (3) For vacation days, the redemption value is assumed to be the monthly salary for pension purposes, divided by 20.83. The usage value is assumed to be the same, with an additional 27.51% factor to reflect social benefits and other costs.
         (4) For vacation days, negative balances were registered as asset. The assumption is that for the majority of cases, such negative balances are settled within a year of the valuation[18].
      ii) Accrued sick days:
         (1) All employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. Additionally for employees who joined Bezeq before 1985 if the sick days are not used up they can be redeemed at the time of leave (no matter what the circumstances of the leave, provided the employee is aged at least 55 on leave). The sick days for utilization are capped at 90 days, after which time some form of disability insurance becomes applicable.[19] Sick days for redemption purposes are not capped.
         (2) Annual accrual of sick days is 30 days per year.
         (3) The accrued sick days, if not used by the time the employee leaves the company, maybe redeemed at their redemption value, which depends on the employee's salary at the time of leave and the level of utilization of sick days throughout his employment history. A high level of

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[18] One could argue that a settlement horizon of a year from valuation falls into the category of short term benefits and should possibly be registered as a short term asset outside this report, which only addresses long-term, termination, and post-employment benefits. However, the judgement on whether a benefit is included in the report or not was made based on the overall benefit provided by the company and not with regard to each employee seriatim.

[19] As the employee accrues future sick days, the utilization will increasingly be from these days (due to the "Last In, First Out" methodology prescribed by IAS 19), until after 5 years there is no more utilization liability. This means that the utilization component is insignificant, and thus for December 2007 we considered only employees with the option to redeem sickness days.

utilization entitles him to a more limited or no redemption value. The following conversion table applies:

Utilization Level		For each 30 Accrued Days	
		Days Accrued Up to 31/12/06	Days Accrued From 1/1/07
From	To		
0%	35%	8 days	7 days
36%	65%	6 days	5 days
66%	100%	0 days	0 days

(4) For sickness the redemption value for a each day is assumed to be the salary for pension purposes with the addition of the monthly "Havraah" amount divided by 25, while the usage values is assumed to be the cost to employer each month divided by 25.
(5) No negative balances for sick days were considered in the valuation.

6) Post-employment benefit liability

a) The calculations of this section of the report refer solely to the liability arising on cessation of employment. Israeli labour laws and agreements require the company to pay severance pay to employees who reach full retirement age, who leave the company's employ under certain conditions (including termination of employment by the employer)[20], who die, or are disabled and unable to continue work. The calculation of the severance pay liability was made in accordance with labour agreement in force and based on salary components that in the management's opinion create entitlement to severance pay.
b) The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.
c) The liability for employee severance pay calculated here represents the unfunded balance of the total liability in respect of severance pay.
d) The amount payable is one monthly salary for each year's employment (which is not subject to § 14 Exemption), based on the final salary prior to termination of employment[21], net of the accrual balance in the severance pay fund.
e) For employees who choose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan and additionally supplements to the full severance pay amount. This forms a constructive obligation and as such is considered a liability under IAS 19.[22]
f) For December 2007, the Company classified additional senior employees as falling under §14 exemptions rules, whereby the Company has no liability to the employee except for release of the saving fund assets. This reclassification

[20] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.
[21] As per Bezeq's directive, the last salary as of date of termination date is used and not the last salary as of the § 14 Exemption date.
[22] As such, we have assumed that all leaves are with full severance pay. See actuarial assumptions below.

led to a decrease in net liability (This reduction is partly due to the early retirement agreement with Bezeq senior employees, as described in paragraph 7).

g) Additionally for senior employees, starting in the 3rd quarter of 2006, the company is obligated, whether contractually or constructively, to pay a multiple of monthly salary to the employee upon termination of employment for whatever reason (hereafter referred to as early notice). The multiple varies by employee (usually 3 or 6 months of salary).

7) Early Retirement

a) In December 2007 the company has reached an agreement with 30 senior "transferred" employees[23] and an additional 4 seniors, who became seniors after 5/12/2006[24], with regard to their early retirement benefits.

b) The pension agreement provides two systems for determining pension rights for retirees among the transferred workers:
   i) Track A – which was determined on the basis of the assessment pension rules in the civil service, i.e. the pension will be determined on the basis of the average of the grades in the last three years prior to the retirement and updated according to the rules for civil servants. The pension in this track is linked to the cost-of-living increments and the wage agreements in the economy.
   ii) Track B – was determined on the basis of the Makefet bylaws, i.e. it sets the pension according to a relative salary average called the "averages method", taking into account the best 25 years[25] (hereinafter: "the Averages Method"). A pension in this track is linked to the CPI on the dates on which a cost-of-living increment was given in the economy.

c) At the beginning of July 2005, an agreement was signed between Bezeq and Harel Insurance Company, whereby Bezeq makes a single payment to Harel at the time of retirement of each employee and Harel takes responsibility for the payment of the old-age and survivors pensions to the early retirees, as detailed below. Bezeq will freeze contributions to the Makefet pension fund in respect of those employees who take early retirement according to this agreement.
   i) Early retirement pension – from the date of the early retirement of the employee until their reaching the statutory retirement age (as defined in the Retirement Age Law, 5764-2004), Harel will pay the retiree a monthly pension according to the amount defined by Bezeq.
   ii) Old age pension – from the month after reaching statutory retirement age, Harel will pay a monthly pension to the retiree, whose sum is the difference between the pension set according to Bezeq and the pension being received from the Makefet Pension Fund under the standard bylaws governing the old pension funds (as defined by the Ministry of Finance).
   iii) Survivors' pension – following the death of the retiree, Harel will pay a pension equal to 60% of the old-age pension (i.e. the difference between

[23] Who became seniors prior to 5/12/2006

[24] The agreement they signed when becoming senior employees, contains an appendix, which specifies their early retirement benefits as matching the early retirement agreement sigend with Bezeq union on 5/12/2006.

[25] As opposed to 35 years average applicable to non-senior employees.

the Bezeq and Makefet pensions) to the spouse of the retiree. Each orphan under age 21 will receive 20% of the old-age pension, up to a maximum of 100% of the basic old-age pension for the spouse and orphans combined. In the event that the 100% limit will be passed, the orphans' share (40%) will be divided equally according to the number of eligible orphans. When an orphan reaches age 21, the orphans' share is reallocated for orphans of a transferred employee, and is not reallocated for the orphans of a non-transferred employee. In the event there is no spouse, each orphan receives a double-share (viz. 40%), while the 100% limit remains in effect.

d) All pensions are linked to the inflation index as defined by the pension fund regulations.

8) Calculation method

a) As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

b) The defined benefit obligation reflects the entitlement earned by active employees only.

c) As per IAS 19.102-4 the individual asset values have been calculated using a discounted cash flow approach.[26]

d) This report (Bezeq seniors) does not reflect most recent interpretations of asset treatment according to IAS 19 of individual assets held in Israeli insurance policies and pension funds. These interpretations were provided after the completion of this report. The approximate impact of the new interpretation on the balance sheet would be a minor reduction (ca. 100,000) in the net liability (net DBO). The impact on the income statement needs to be reviewed in future reports.

[26] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cash flow approach is suitable.

A3 – Pelephone

9) Post-employment benefit liability

a) Israeli labour laws and agreements require the company to pay severance pay to dismissed[27] or retiring employees (including those leaving their employment under certain other circumstances such as death or disability). The calculation of the severance pay liability was made in accordance with the agreements in force and based on salary components that in the management's opinion create entitlement to severance pay.
b) The company's severance pay liabilities to some of their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.
c) The amount payable is one monthly salary for each year's employment, based on the final salary prior to termination of employment, net of the accrual balance in the severance pay fund.
d) Additionally, for employees who chose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan, if they own such a plan (only 43 employees out of 6,610). This forms a constructive obligation and as such is considered a liability under IAS 19.
e) The company maintains separate bank deposits intended solely to cover any liabilities arising from employee's severance pay. These amounts are small and are not included in this report.
f) Lastly, the company offers to a selected number of employees an early notice benefit, whereby employees upon informing the company or being informed by the company of their forthcoming leave, the company in some cases provides one to six months of salary without the employees continuing his employment. This benefit is also paid upon retirement. This benefit was first introduced in the 3rd quarter of 2006.
g) The liability for employee severance pay calculated here represents the unfunded balance of the total liability.

10) Long-Term benefit liability

a) All employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. However, the company does not offer a redemption option for un-used sick days.
b) All employees accrue vacation days, with the annual accrual being dependent on the individual employee's employment contract. These days can be utilised in the future, or redeemed, as the employee desires. The company has informed us that the cost of utilising or redeeming the vacation days is the same.
c) A few employees have a negative balance, which is recognized a negative liability, as the employees for the time being have to "pay back" the over-used vacation privilege. [28]

[27] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[28] If an employee leaves with a negative balance, the company settles the open balance, just as it settles a positive balance with any employee terminating his service under whatever circumstances.

11) Calculation method

a) As required by IAS 19.64 the calculation has been performed using the projected unit credit method.
b) The defined benefit obligation reflects the entitlement earned by active employees only.
c) As per IAS 19.102-4 the individual asset values have been calculated using a discounted cashflow approach.[29]
d) This report (Pelephone) does not reflect most recent interpretations of asset treatment according to IAS 19 of individual assets held in Israeli insurance policies and pension funds. These interpretations were provided after the completion of this report. However, since most of the policies have a guaranteed return, which is allocated to the Pitzuim portion, the impact on the net severance liability would be minor. The impact on the income statement needs to be reviewed in future reports.

[29] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

A4 – Yes

12) Post-employment benefit liability

a) Severance Pay
   i) Israeli labour laws and agreements require the company to pay severance pay to dismissed[30] or retiring employees (including those leaving their employment under certain other circumstances such as death or disability). The calculation of the severance pay liability was made in accordance with the agreements in force and based on salary components that in the management's opinion create entitlement to severance pay.
   ii) The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies.
   iii) The company does not maintain any separate bank accounts/central severance pay funds intended solely to cover any liabilities arising from employee's severance pay.
   iv) The amount payable is one monthly salary for each year's employment, based on the final salary prior to termination of employment, and depending on the personal agreement, usually net of the accrual balance in the severance pay fund.
   v) For some employees, the company has signed an agreement under paragraph 14 of the severance pay law[31], whereby the company makes regular deposits of 8.33% of salary into a recognised severance pay fund. The accrued balance in this fund covers any future severance pay obligation, and the company does not need to supplement this amount. There is thus no further liability for these employees once the agreement is signed. The company maintains a liability only on that period of service up to the time of signing the agreement, which is reflected in the calculations below. This liability is calculated at the time of severance as period of time until paragraph 14 agreement is signed multiplied by the final salary at the time of leave.
   vi) Under Israeli law severance pay is paid only to employees with over one year of service with the company. Nevertheless, employees with less than one year's service are included in the valuation, as their first year of service forms a constructive obligation towards future payments, as required by IAS 19.69.
   vii) The liability for employee severance pay calculated here represents the unfunded balance of the total liability.

[30] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[31] חוק פיצויי פיטורים, תשכ"ג-1963

13) Long-Term benefit liability

a) Vacation Days
   i) Employees accrue vacation days, where the number of days accrued each year varies by employee according to his/her contract and period of service (up to a maximum of 22 days per year). There is no limit as to the total number of days that an employee can accrue.
   ii) Generally employees have some accrued vacation day balance, which they are entitled to utilize or redeem at some point in the future. The utilization cost per day is calculated by the company as salary divided by 22. There is an additional cost for social benefits and taxes, which is estimated at 26% of salary for both utilization and redemption. Employees can also elect to redeem their accrued vacation days at any time, at the same cost to the company as utilization.
   iii) A few employees have a negative balance, which is recognized a negative liability, as the employees for the time being have to "pay back" the over-used vacation privilege. [32]
   iv) The company holds a provision for vacation day usage of senior management. This was supplied to us as a single figure, and has been added directly to the liability figures without our performing any actuarial calculations. Any change in the liability has been placed in the current service cost figure.

b) Sick Days
   i) Employees accrue sickness days, where the number of days varies by employee according to his employment years and contract, according to the legal requirements in Israel. An employee can accrue up to 90 sick days.
   ii) Accordingly employees have accrued sick days, which can be utilized over the remainder of the employment when need arises. The accrued sick days can be used upon an employee's disability until he surpasses the waiting period or generally 90 days.
   iii) Employees are not entitled to redeem unused sick days at any time.
   iv) Given the young average age of the company and the fact that there is no redemption benefit for sick days, renders this benefit to be of negligible expected cost at this stage and is not included in the valuation.

14) Calculation method

a) As required by IAS 19.64 the calculation has been performed using the projected unit credit method.
b) The defined benefit obligation reflects the entitlement earned by active employees only.
c) As per IAS 19.102-4 the individual asset values have been calculated using a discounted cashflow approach.[33]

[32] If an employee leaves with a negative balance, the company settles the open balance, just as it settles a positive balance with any employee terminating his service under whatever circumstances.

d) This report (Yes) does not reflect most recent interpretations of asset treatment according to IAS 19 of individual assets held in Israeli insurance policies and pension funds. These interpretations were provided after the completion of this report. The approximate impact of the new interpretation on the balance sheet would be the cancellation of net liability (net DBO) of ca. 600,000 NIS. The impact on the income statement needs to be reviewed in future reports.

[33] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cash flow approach is suitable.

A5 – Bezeq International

15) Post-employment benefit liability

a) Severance Pay
   i) Israeli labour laws and agreements require the company to pay severance pay to dismissed[34] or retiring employees (including those leaving their employment under certain other circumstances such as death or disability). The calculation of the severance pay liability was made in accordance with the agreements in force and based on salary components that in the management's opinion create entitlement to severance pay.
   ii) The company's severance pay liabilities to their employees are funded partially by regular deposits with recognized pension and severance pay funds in the employees' names and by purchase of insurance policies. The company does not maintain a separate bank account intended solely to cover any liabilities arising from employee's severance pay (Kuppa Merkasit LePitzuim).
   iii) The amount payable is one monthly salary for each year's employment, based on the final salary prior to termination of employment, and depending on the personal agreement, usually net of the accrual balance in the severance pay fund. There are no exceptional employees, whose personal contract provides for a severance pay, which is a multiple for each year of service.
   iv) Additionally, for employees who chose to end their period of employment with the company, the company in most cases releases to the employee their individual savings plan, if they own such a plan. This forms a constructive obligation and as such is considered a liability under IAS 19.
   v) The liability for employee severance pay calculated here represents the unfunded balance of the total liability.

b) Early notice: for senior employees the company provides a benefit of 3 months salary upon leave[35] of the employee irrespective if voluntary or by termination. Since the expected average life-time of senior employees per management's assessment is two to three years, the impact of an actuarial valuation on this benefit (or the part of the benefit, which is post short-term benefit) is negligible when compared with the straight forward valuation methodology the company currently applies. Hence, this benefit is not included in this valuation and the reserve should be held according to current methodology (last salary x number of early notice months).

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[34] As per advice from the accountants, we are not treating these benefits as termination benefits under IAS 19, but rather as post-employment benefit.

[35] Generally, without providing any services to the company during this period.

16) Long-Term benefit liability

a) Vacation Days

i) Employees accrue vacation days, where the number of days varies by employee according to his employment years and contract. There is no cap on vacation accruals.

ii) Generally employees have some accrued vacation day balance, which they are entitled to utilize or redeem at some point in the future. The utilization cost to the company includes social benefit costs plus additional employment related expenses, such as car maintenance. Employees can also elect to redeem their accrued vacation days, in which case the company pays salary without the approximately 25% social benefit cost. However, this has been very uncommon and hence we assumed all days would be utilized.

iii) A few employees have a negative balance, which is recognized a negative liability, as the employees for the time being have to "pay back" the over-used vacation privilege[36].

b) Sick Days

i) The company does not provide any option for redeeming the accrued unused sick days.

ii) As the company's employees are young and since there is no cap on accruing sick days, the liability – if any – for actual expected sick days is negligible and not computed for this report.

17) Calculation method

a) As required by IAS 19.64 the calculation has been performed using the projected unit credit method.

b) The defined benefit obligation reflects the entitlement earned by active employees only.

c) As per IAS 19.102-4 the individual asset values have been calculated using a discounted cash flow approach.[37] For Bezeq International we were informed that the insurance policies are credited with interest. This behaviour diverges from the standard past practice for these type of policies, which are generally not credited with interest, but instead the interest earnings are allocated to the non-severance part of the account.

d) This report (Bezeq International) does not reflect most recent interpretations of asset treatment according to IAS 19 of individual assets held in Israeli insurance policies and pension funds. These interpretations were provided after the completion of this report. The approximate impact of the new interpretation on the balance sheet would be the cancellation of net liability (net DBO) of ca. 1,200,000 NIS. The impact on the income statement needs to be reviewed in future reports.

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[36] If an employee leaves with a negative balance, the company settles the open balance, just as it settles a positive balance with any employee terminating his service under whatever circumstances.

[37] The assets are invested in plans, which match the amount and timing of some or all of the liabilities. As such their value should equal the corresponding liabilities, and therefore a discounted cashflow approach is suitable.

Section B – Data basis

B1 - Bezeq

18) Data basis

a) The calculations are based on the data supplied to us by Bezeq as of the valuation date. We have relied upon these data, which have been prepared by the responsible employees of the company. We have not checked these data, although the company has confirmed that the data supplied to us are accurate. We have reviewed all key data for reasonableness.

b) In particular, we have relied upon Bezeq to supply us with the full population that is relevant for each benefit.

c) The following tables summarise the data on which the valuation was based:

i) Severance pay (no §14 exemption):

	31/12/2004	31/12/2005	31/12/06	31/12/07
Number of employees	1,049	1,077	1,112	673
Total Salary	8,046,009	9,846,932	10,916,910	6,680,320
Total Service	5,625	6,641	7,608	4,582
Total Liability	56,030,080	69,888,755	83,153,355	48,120,099
Total Assets	54,127,113	63,146,151	70,160,462	41,847,253

(1) For December 2007, the Company has reviewed the population who are not subject to the paragraph 14 exemption, which has resulted in a considerable reduction in the size of this population. However, this change had only a minor effect on the net liability, due to individual savings balances equalling approximately the gross liability.

ii) Severance pay (with § 14 exemption) – liability for first year (approximately) of employment only.

	31/12/2005	31/12/2006	31/12/2007
Number of employees	1,594	2,243	2,699
Total Salary	5,866,901	8,383,023	10,227,298
Total Service	1,217	1,639	1,832
Total Liability	4,490,372	6,392,019	7,510,713

iii) Sickness:

	31/12/2005	31/12/2006	31/12/2007
Number of employees	8,114	7,927	7,467
Total gross sickness days accrued	2,635,504	2,749,658	2,018,526
Total gross sickness days used/redeemed	1,075,866	1,120,910	635,095
Net sickness days accrual	1,559,638	1,628,748	1,383,431
Average redemption value for sickness day	253	286	273
Average usage value for sickness day	322	365	351

iv) Vacation:

	31/12/2005	31/12/2006	31/12/2007
Number of employees	8,114	7,928	7,470
Total gross vacation days accrued	1,882,064	1,975,001	142,948
Total gross vacation days used/redeemed	1,722,109	1,812,976	0
Net vacation days accrual	159,955	162,025	142,948
Average redemption value for vacation day	283	298	306
Average usage value for vacation day	360	380	393

v) Retirees:

Population	Dec-05	Dec-06	Dec-07
Active	4,434	4,375	3,674
Retiree	5,571	5,630	6,178
Spouses	869	869	918

B2 – Bezeq Seniors

19) Data basis

a) The calculations are based on the data supplied to us by Bezeq as of the valuation date. We have relied upon these data, which have been prepared by the responsible employees of the company. We have not checked these data, although the company has confirmed that the data supplied to us are accurate. We have reviewed all key data for reasonableness.
b) In particular, we have relied upon Bezeq to supply us with the full population that is relevant for each benefit.
c) With regard to the savings balances for 31/12/2006, we have not received such balances and have estimated them based on opening balances and deposits made as recorded by the company.
d) For some employees the number of accrued sick days was corrected for the December 2007 valuation, which led to a moderate increase in liability.
e) For December 2007 some additional employees were classified as senior employees and were thus added to this report.

B3 - Pelephone

20) Data basis

a) The calculations are based on the data supplied to us by Pelephone as of the requested valuation dates. In addition some data has been provided for dates preceding the first valuation date, such that the underlying statistical analysis uses some information, which is independent of the valuation dates at hand.
b) I have relied upon these data, which have been prepared by the responsible employees of the company. I have not checked these data, although the company has confirmed that the data supplied to me are accurate. I have reviewed all key data for reasonableness.
c) With regard to senior employees, we have received a single liability figure and no actuarial calculations were performed as per the understanding of management and accountants the impact would be negligible on the entire balance sheet. The provided total liability is included in this report.
d) Vacation day cost was provided without including social benefit costs of a 32%, which were added externally to the report. This augmentation was applied to the vacation day benefits of employees, as well as the information provided for senior employees separately (see 4) c).
e) With regard to the early notice benefit for non-senior employees, we have been provided with partial benefits paid information, as the company needs to revise the way this benefit given to employees who leave is kept track off. As such, current actuarial apparent gains in this area of reporting, is not reflective of the actual situation, which over time will become more accurate.
f) Early notice benefit includes social benefits cost of 16%, to reflect the assumption that half of the employees entitled to that benefit will receive in the form of a lump sum payment, while the other half will receive the benefit as an ongoing salary. For the group receiving a lump sum payment the liability is without social benefits loading, while the second group has additional social benefit cost to the employer of 32%. Hence, we loaded the salaries provided by 16% (50% * 32% + 50% * 0%).

B4 - Yes

21) Data basis

a) The calculations are based on the data supplied to us by DBS Ltd. as of the requested valuation dates. In addition some data has been provided for dates preceding the first valuation date, such that the underlying statistical analysis uses some information, which is independent of the valuation dates at hand.
b) I have relied upon these data, which have been prepared by the responsible employees of the company. I have not checked these data, although the company has confirmed that the data supplied to me are accurate. I have reviewed all key data for reasonableness.
c) Up to an including December 2006 senior employees were not included in the data and were added as an external adjustment to the results. For December 2007 senior employees are included in the data.

d) Severance Pay
   i) We were provided with the following information relating to severance pay obligations:

	Number of Employees	Total Service	Total Salaries	Average Service	Average Salary	Nominal Assets	Gross Nominal Liability
31/12/2005	1569	3,956	9,391,998	2.52	5,986	5,400,828	11,251,803
31/12/2006	1500	4,244	9,700,484	2.83	6,467	5,621,825	13,036,930
31/12/2007	1582	1,843	8,041,458	1.16	5,083	6,809,647	13,191,191

   (1) For the December 2007 valuation the company has provided a more complete list of employees for whom the paragraph 14 exemption applies, resulting a decrease in net liability of 760k. This change can be seen in appendix I under “Change in Population – Seif 14”. For employees who left during 2007 we did not receive information about which employees have paragraph 14 exemption and there for these are all classified as regular leaves. For December 2007 the company considers the list of paragraph 14 exemption to be accurate and complete.
   (2) Additionally the company has identified a group of 1,296 employees who has a partial paragraph 14 exemption, resulting a decrease in net liability of 900,000 NIS.
   (3) For December 2007 the data included senior employees for the first time. For severance pay this is the first time seniors are been included in the report, leading to increase in net liability of 380k which can be seen under “Addition Senior Employees”. For vacation pay the senior employees were previously included as an external adjustment on a nominal basis. Changing to an actuarial basis lead to a decrease in liability of 151,000 NIS.

   ii) We were provided with the following information regarding vacation days accrual:

Valuation Date	Number Of Employees	Net Vacation Days Accrued	Total Redemption Value	Total Utilization Value	Average Accrual Days	Average Redemption Value	Total Liability By Redemption	Total Liability By Utilization
31/12/2005	1,710	15,786	543,576	543,576	9.23	318	6,501,721	6,501,721
31/12/2006	1,649	16,192	556,036	556,036	9.82	337	7,209,701	7,209,701
31/12/2007	1,884	17,187	536,670	664,587	9.12	285	7,623,979	9,478,876

(1) In the data for December 2007 the company differentiated for the first time between vacation day redemption value and vacation day usage value, whereby the latter includes social costs while the former did not. Previously all values included social costs, thus this change results in a decrease in liability.

B5 – Bezeq International

22) Data basis

a) The calculations are based on the data supplied to us by Bezeq International as of the requested valuation dates. In addition some data has been provided for dates preceding the first valuation date, such that the underlying statistical analysis uses some information, which is independent of the valuation dates at hand.
b) Following a review of the data basis for vacation day value, the values for some employees have been corrected in December 2007. This leads to an increase of 1.160M NIS, which can be seen under "Data Correction" in Appendix One.
c) The results for September 2007 were presented on a "roll-forward" basis, without inclusion of actuarial gains/losses. The current report has been performed based on actual data, and thus the actuarial gains/losses for the previous quarter have been also included in the current report. These amount to 99k NIS and 2.508M on the vacation and severance benefits respectively, which can be seen under "Deviations Carried Over Q3" in Appendix I.
d) I have relied upon data prepared by the responsible employees of Bezeq International. These data have not been checked by me, although the Bezeq International has confirmed that the data supplied to me are accurate. I have reviewed all key data for reasonableness
e) Severance Pay
   i) We were provided with the following information relating to severance pay obligations:

Valuation Date	Number Employees	Total Salary	Total Service	Total Savings	Gross Nominal Liability
31/12/2006	1,440	8,838,188	2,874	15,413,866	24,280,418
30/06/2007	1,980	11,217,309	4,908	26,128,746	37,654,375
30/09/2007	2,098	11,455,775	4,957	26,684,344	38,930,595
31/12/2007	1,902	11,290,348	4,750	27,580,014	40,297,027

f) Vacation Days
   i) We were provided with the following information regarding vacation day accrual:

Valuation Date	Number Employees	Total Net Accrued Vacation Days	Total Vacation Day Value	Gross Nominal Liability
31/12/2006	1440	9,053	419,964	4,045,236
30/06/2007	1980	13,266	577,000	5,963,264
30/09/2007	2098	13,460	595,344	6,291,049
31/12/2007	2042	12,967	680,042	6,879,999

Section C – Actuarial Assumptions

C1 - Bezeq

23) Actuarial assumptions

a) The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:
   i) Mortality rates vary depending on the particular benefit that is being valued:
      (1) In general the rates are based on the Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts.[38]
      (2) For the purpose of the early retirement benefits the basis is as follows:
         (a) December 2004: valuation is based on the rates published in circular 2000/1 as per instructions from the Ministry of Finance contained in a letter the ministry published in 1999 for early retirement programs through Makefet Pension Fund.
         (b) Starting in 2005, the rates used reflect the agreement reached with Harel[39].
         (c) For the full retirement valuation, which is still a quite deferred benefit and which is assumed to be provided by an insurer rather not a pension fund, we assumed the rates contained in circular 2007-1-3 as an estimate of the rates that would be in effect at the time the Bezeq would purchase policies to cover this benefit.

   ii) For December 2007, disability rates are based upon table 8פ in the Ministry of Finance pension circular 2007-3-6. Previous valuations used table 2.א. of pension circular 2000-1. This change led to an increase in sickness liability of 6.7 M NIS.

   iii) The leave rates assumed, based on the experience of the company over the five years 2001-2006, and which assumes that all leaves are compensated with full severance pay, is split into three categories of employees: permanent/tenured ones which have Dirug 90 or not, and temporary employees (Office code 796):

Years of	Permanent/Tenured		Temporary
Employment	Dirug 90	Non-Dirug 90	Office Code 796
1	5.50%	3.50%	34.18%
2	5.50%	3.00%	35.75%
3	5.50%	2.64%	26.83%

[38] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf. The Ministry of Finance has also issued updated mortality tables for pension funds, however, the impact of switching between the two is not significant.

[39] This basis is considered a reasonable proxy to the economic value of the benefit. It is assumed that to the degree the mortality basis would be too aggressive or conservative, the agreement with Harel would have compensated for such deviations through higher or lower interest spreads, which are also included in the valuation.

4	5.50%	2.29%	21.14%
5	5.50%	1.93%	21.29%
6	5.50%	1.57%	30.67%
7	5.50%	1.21%	25.00%
8	5.50%	0.86%	25.00%
9	5.50%	0.50%	25.00%
10+	5.50%	0.50%	25.00%

iv) Early retirement expectations: based on the following percents for each valuation period (consistent with the early retirement actuarial report provided to Bezeq each quarter.) Employees with a known early retirement date were not included in the other benefit valuations.

(1) For December 2007 only 6 early retirement places remained unallocated. This has a negligible impact on the other benefit valuations and was not included.

v) Accrued Sick days:

(1) Utilization: Based on the company's experience (over the limited period submitted), the annual accrual of sick days (which is not capped) is more than sufficient to cover ongoing needs for sick day leaves. As such the accrued balance of sick days generally is not expected to be put to use to cover such future expenses and no IAS 19 liability exists. Occasionally there are a few cases, which use accrued sick days due to an extended sickness period. However, they are quite limited. In addition, since IAS 19 requires the methodology of LIFO in accounting for the use of accrued benefits, the sick days to be used in a future projection in excess of the then annual accrual, would mostly be using future sick day accruals. Only for the next few years may part of the accrued sick day balance maybe used for such sickness incidences. I consider these incidences of immaterial size and have excluded them from this valuation.[40] As the population ages, this assumption maybe reviewed and the report modified based on evolving experience.

(2) Redemption Value: We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1)a)ii)(3), and expected usage rates as follows: for permanent employees – for females, 18 days per year; for males, 8.3 days per year at age 24 and below, falling linearly to 2.3 days per year from age 36. For temporary employees we have assumed 9 days usage per year.[41] The future projection assumes a "last in first out" methodology.

vi) Accrued vacation days:

(1) Utilization – for permanent employees, it is assumed that in each year there is accrual of additional vacation days. When the limit on the

[40] With the exception of cases of disability, which are assumed to use the maximum allowable number of days: either the net accrued days, or 90 days, whichever is lower.

[41] These assumptions mean that the current accrual will be carried forward to redemption, except in the case of disability, where there is a slow reduction in the usage of the current days, as noted in footnote 4.

number of accrued days is reached, we have assumed that no further days are added to the existing accrual[42]. For temporary employees, in the early years of service, it is possible that there can be utilization of existing vacation days. These utilizations are included in the valuation figure.

(2) Redemption value - We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1)a)i)(1), and an expected usage of 20 vacation days per year in the future, for both males and females, for permanent employees and 12 vacation days per year in the future, for both males and females, for temporary employees. These figures are borne out by statistical analysis of the current data, in which no clear dependency of level of utilization and age could be detected thus far. The future projection assumes a "last in first out" methodology.

b) In view of the limited number of years experience currently available, these assumptions were felt to be reasonable. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

c) The calculations are based on the following financial assumptions:

i) The discount rate used is based on the yield of fixed-interest Israeli government bonds[43] with duration equal to the duration of the gross liabilities:

	Valuation	Duration of Liability (Years)				Discount Rate			
	Date	Dec-04	Dec-05	Dec-06	Dec-07	Dec-04	Dec-05	Dec-06	Dec-07
A.1	Severance	11.83	11.7	11.47	11.46	4.16%	3.75%	3.60%	3.53%
A.2	Severance - 1st Year	8.14	7.05	4.08	6.81	3.93%	3.61%	3.68%	3.38%
B	Sick Days	18.49	18.71	17.25	19.71	4.38%	3.89%	3.60%	3.62%
C	Vacation Days	14.7	14.49	11.27	15.55	4.26%	3.81%	3.61%	3.60%
D.1	Holiday Gift	14.11	13.92	13.84	14.84	5.63%	5.20%	5.20%	5.32%
D.2	Clubs	15	14	13.5	13.31	4.27%	3.80%	3.60%	3.58%
D.3	Activities	14.11	13.92	13.84	13.31	4.24%	3.80%	3.60%	3.58%

ii) The discount rate for holiday gifts is based upon American corporate bonds rated grade AA or higher, in accordance with IAS 19.78 that "the currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations."

[42] In accordance with the "last in first out" methodology prescribed by IAS 19.

[43] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used amount yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

iii) Discount rate for early retirement pension payments: as per the agreement with Harel, the liabilities are discounted on an individual basis according to the gross redemption yield on government bonds with duration closest to that of the liability, and using linear interpolation between such durations. From this discount rate an amount representing the spread agreed with Harel was deducted. Additionally, in the event the calculated liability for an employee was within 3 years of the modified duration of the government bond ("Galil" series) with the highest duration, then this duration was used as the gross interest rate.

(1) Discount rate from evaluation to expected retirement day: we discounted the expected cost from evaluation to expected retirement day, according to the return rate on the bond with the closest duration from below during the discounted duration.

Series	*Modified Duration*	*Interest Rate*
Galil 5416	0.20	2.326%
Galil 5704	0.20	1.616%
Galil 5417	0.37	1.738%
Galil 5481	0.61	3.202%
Galil 5705	0.70	1.234%
Galil 5470	0.70	3.271%
Galil 5471	0.78	3.416%
Galil 5706	0.95	1.977%
Galil 5472	1.02	3.452%
Galil 5418	1.16	1.663%
Galil 5707	1.58	1.784%
Galil 5903	1.65	3.619%
Galil 5419	1.83	2.073%
Galil 5420	1.96	2.209%
Galil 5901	2.17	2.324%
Galil 5421	2.50	2.444%
Galil 5415	2.55	0.467%
Galil 5422	2.58	2.484%
Galil 5423	2.82	2.424%
Galil 5480	3.56	3.088%
Galil 5424	4.25	2.656%
Galil 5427	4.35	3.192%
Galil 1065	5.28	2.882%
Galil 5425	6.04	2.817%
Galil 5426	6.30	2.887%
Galil 5904	10.77	3.627%
Galil 0977	12.49	3.708%

iv) Salary increase assumptions:

(1) For permanent employees, we assumed, based on the company's experience: 6% per annum at age 20 falling linearly to 1.75% per annum at age 60.

(2) For temporary employees, we have assumed 0.45% per annum at all ages.[44]

v) Holiday Bonus: The bonus is set at $100 per annum, where we used the following foreign exchange rates and VAT assumptions. The bonus amount does not include any social costs or taxes.

	12/2004	12/2005	12/2006	12/2007
$/NIS	4.308	4.603	4.200	3.846
VAT	17.0%	16.5%	15.5%	15.5%

No real increase is assumed. For active employees the benefit is recorded based on the accrued service period relative to expected total service period, where the total expected service period includes expectations of early retirement for the pool of qualifying employees.[45]

vi) Clubs: Based on the assumption of 2.10 million NIS annual expense[46] on behalf of Bezeq, which is allocated between current retirees based on 100% accrual and future expected retirees based on their accrued seniority fraction. For example, for an employee who is expected to retire at age 63 after 30 years of service and he has currently 20 years of service, a factor of 2/3 is applied towards is expected chance of benefiting from this benefit in the future.

vii) Activities: An assumed per family expense of 300 NIS for the valuation periods 12/2004 and 12/2005 and an increased expense of 332 for 12/2006 and 12/2007. No real increase is assumed.

viii) The rate of growth of the accrued balance in individual savings plans is assumed to be 2.0% p.a. This reflects the fact that the majority of the savings balances are in old pension funds, where there is a fixed formula for the redemption value of the funds. This approach is slightly conservative, as some of the funds are invested in participation policies in insurance funds and some in new pension funds, and we would expect the long-term net real returns on these funds to be higher.

[44] As we assume high leave rates for these employees, based on the company's experience, the impact of the low salary increase assumption is small.

[45] The fractional recognition of the liability in respect of accrued service period is applied across the board to all benefit elements: retire, disabled, active survivor, retired survivor. One could argue that in respect of active survivor and disabled benefits, the benefit has already fully accrued and as such IAS 19 would require a full recognition of such benefits. This point is under clarification. In any event, the impact is expected to be negligible, as the fully vested retirees and the retirement benefit of actives carry the lion's share of the liability.

[46] Representing an increase from 1.85 M NIS in December 2006.

C2 – Bezeq Seniors

24) Actuarial assumptions

d) The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:
   i) Mortality rates are based on the recently published Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts[47]. For the early retirement benefit, the rates are based upon the rates agreed with Harel Insurance Company.
   ii) For December 2007, disability rates are based upon table 8פ in the Ministry of Finance pension circular 2007-3-6. Previous valuations used table 2.א. of pension circular 2000-1.[48]
   iii) The leave rates assumed, based on management's assessment of future expected leaves, are 20% per annum.

   iv) Accrued Sick days:
      (1) Utilization: Based on the company's experience (over the limited period submitted), the annual accrual of sick days (which is not capped) is more than sufficient to cover ongoing needs for sick day leaves. As such the accrued balance of sick days generally is not expected to be put to use to cover such future expenses and no IAS 19 liability exists. Occasionally there are a few cases, which use accrued sick days due to an extended sickness period. However, they are quite limited. In addition, since IAS 19 requires the methodology of LIFO in accounting for the use of accrued benefits, the sick days to be used in a future projection in excess of the then annual accrual, would mostly be using future sick day accruals. Only for the next few years may part of the accrued sick day balance maybe used for such sickness incidences. I consider these incidences of immaterial size and have excluded them from this valuation.[49] As the population ages, this assumption maybe reviewed and the report modified based on evolving experience.
      (2) Redemption Value: We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1)a)ii)(3), and expected usage rates as follows: for permanent employees – for females, 18 days per year; for males, 8.3 days per year at age 24 and below, falling linearly to 2.3 days per year from age 36.[50] The future projection assumes a "last in first out" methodology.

   v) Accrued vacation days:

[47] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf
[48] This change did not have a significant impact on the liability.
[49] With the exception of cases of disability, which are assumed to use the maximum allowable number of days: either the net accrued days, or 90 days, whichever is lower.
[50] These assumptions mean that the current accrual will be carried forward to redemption, except in the case of disability, where there is a slow reduction in the usage of the current days, as noted in footnote 4.

(1) Utilization – it is assumed that in each year there is accrual of additional vacation days. When the limit on the number of accrued days is reached, we have assumed that no further days are added to the existing accrual[51].

(2) Redemption value - We have projected forward the expected number of days to be redeemed by using rates of accrual as described above in section 1)a)i)(1), and an expected usage of 20 vacation days per year in the future, for all employees. These figures are borne out by statistical analysis of the current data, in which no clear dependency of level of utilization and age could be detected thus far. The future projection assumes a "last in first out" methodology.

e) In view of the limited number of years experience currently available, these assumptions were felt to be reasonable. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

f) The calculations are based on the following financial assumptions:

i) The discount rate used is based on the yield of fixed-interest Israeli government bonds[52] with duration equal to the duration of the gross liabilities:

	Duration			***Interest Rate***		
	31/12/2005	**31/12/2006**	**31/12/2007**	**31/12/2005**	**31/12/2006**	**31/12/2007**
Severance Pay	4.27	4.20	4.57	3.50%	3.67%	3.26%
Vacation	4.42	4.32	6.11	3.50%	3.67%	3.31%
Sickness	4.61	4.30	4.47	3.50%	3.67%	3.61%
Early Notice	-	4.59	4.67	-	3.66%	3.27%

ii) Salary increase assumptions – based upon management's assessment of future expected salary increases for senior employees, we have assumed a rate of 6% per annum.

iii) Discount rate for early retirement pension payments: as per the agreement with Harel, the liabilities are discounted on an individual basis according to the gross redemption yield on government bonds with duration closest to that of the liability, and using linear interpolation between such durations. From this discount rate an amount representing the spread agreed with Harel was deducted. Additionally, in the event the calculated liability for an employee was within 3 years of the modified duration of the government bond ("Galil" series) with the highest duration, then this duration was used as the gross interest rate.

[51] In accordance with the "last in first out" methodology prescribed by IAS 19.

[52] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used amount yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

(1) Discount rate from evaluation to expected retirement day: we discounted the expected cost from evaluation to expected retirement day, according to the return rate on the bond with the closest duration from below during the discounted duration.

Series	*Modified Duration*	*Interest Rate*
Galil 5416	0.20	2.326%
Galil 5704	0.20	1.616%
Galil 5417	0.37	1.738%
Galil 5481	0.61	3.202%
Galil 5705	0.70	1.234%
Galil 5470	0.70	3.271%
Galil 5471	0.78	3.416%
Galil 5706	0.95	1.977%
Galil 5472	1.02	3.452%
Galil 5418	1.16	1.663%
Galil 5707	1.58	1.784%
Galil 5903	1.65	3.619%
Galil 5419	1.83	2.073%
Galil 5420	1.96	2.209%
Galil 5901	2.17	2.324%
Galil 5421	2.50	2.444%
Galil 5415	2.55	0.467%
Galil 5422	2.58	2.484%
Galil 5423	2.82	2.424%
Galil 5480	3.56	3.088%
Galil 5424	4.25	2.656%
Galil 5427	4.35	3.192%
Galil 1065	5.28	2.882%
Galil 5425	6.04	2.817%
Galil 5426	6.30	2.887%
Galil 5904	10.77	3.627%
Galil 0977	12.49	3.708%

iv) The rate of growth of the accrued balance in individual savings plans is assumed to be 3.0% p.a. This reflects the fact that the majority of the savings balances are in managers' insurance policies (*bituach menahalim*).

C3 - Pelephone

25) Actuarial assumptions

a) The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:
   i) Mortality rates are based on upon the rates specified in the draft insurance circular 2006-319 issued by the Israeli Ministry of Finance, including future mortality improvements.
   ii) Disability rates are based upon table 2.א. of the pension circular 2000/1 of the Ministry of Finance.
   iii) The leaves assumed differentiating between with entitlement to full severance pay ("With" column) and without severance pay, based on the experience of the company, is as follows:

	Senior		**Non-senior**	
Year	**With**	**Without**	**With**	**Without**
1	8.0%	12.0%	5.0%	45.0%
2	8.0%	11.0%	25.0%	17.0%
3	8.0%	10.0%	25.0%	7.0%
4	8.0%	9.0%	25.0%	7.0%
5	8.0%	8.0%	25.0%	7.0%
6	8.0%	7.0%	25.0%	7.0%
7	8.0%	6.0%	25.0%	7.0%
8	8.0%	5.0%	25.0%	7.0%
9	8.0%	4.0%	25.0%	7.0%
10	8.0%	3.0%	25.0%	7.0%
11+	8.0%	2.5%	25.0%	7.0%

   iv) Accrued Sick days:
      (1) Utilization: Given the young age of the population and the big turn-over, there is no noticeable accrued liability for sick days and generally sick days will be used from future accrued sick days.
      (2) Redemption: no redemption benefit for sick days exists at Pelephone.

v) Accrued Vacation days:

(1) The future annual usage of vacation days according to age, and based on the company's experience, is as follows:

Age	Usage	Age	Usage
21	5.65	**31**	12.15
22	6.30	**32**	12.80
23	6.95	**33**	13.45
24	7.60	**34**	14.10
25	8.25	**35**	14.75
26	8.90	**36**	15.40
27	9.55	**37**	16.05
28	10.20	**38**	16.70
29	10.85	**39**	17.35
30	11.50	**40+**	18.00

b) In view of the limited number of years experience currently available, these assumptions were felt to be reasonable. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

c) The calculations are based on the following financial assumptions:

i) The discount rate used is based on the yield of fixed-interest Israeli government bonds[53] with duration equal to the duration of the gross liabilities:

	Duration of Liability (Years)			Discount Rate		
Valuation Date	**Severance**	**Early Notice**	**Vacation Days**	**Severance**	**Early Notice**	**Vacation Days**
12/2004	4.78		3.84	3.46%		3.28%
12/2005	4.88		3.74	3.50%		3.50%
12/2006	4.59	7.68	3.75	3.66%	3.63%	3.50%
12/2007	4.44	6.69	3.91	3.30%	3.40%	3.29%

[53] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used amount yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

ii) Salary increase assumptions:
   (1) Based on recent experience of the company, we arrived at the following salary development for senior employees (department and division managers): At age 21, use 4% salary increase, which increases linearly to 14% at age 28. Until age 39 the salary increase declines to 2.5% and remains there until retirement.
   (2) Non-senior employees: age 21 to 28 use 16% salary increase. Until age 39 the salary increase declines to 2.5% and remains there until retirement.

iii) The rate of growth of the accrued balance in individual savings plans, which were issued before 1/1/1990 is assumed to be 4.25% p.a., which reflects the insurance plan of noticeable seniority. For policies issued after 31/12/1989, I assumed 3.0% (4.0% earnings rate minus 1.0% management fee). For a small interim period of 2 years this is a slightly conservative assumption, as there was still some partial Government subsidy to the savings account. However, the simplification, in my opinion, does not create a material deviation. As per management's confirmation, the severance component of the savings plan indeed receives interest earnings. This treatment differs from the default approach insurance companies have taken in the past, where the interest earned on severance policies was generally allocated to the Tagmulim portion of the account.

iv) The rate of growth of the separate plan assets is assumed to be 3.0% p.a. This reflects 4.0% expected market return after the deduction of 1.0% management fees.

v) Early notice benefit: the company has not kept track in a clear way as to when the benefit is utilized and when the company continued paying the regular salary, as the person elected to work until the last day before his leave. For this valuation management has proposed that one month's pay be assumed for department managers and three months' salary for the division managers and six months' pay for vice presidents.

C4 - Yes

26) Actuarial assumptions

a) The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:
   i) Mortality rates are based on the Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts.[54]
   ii) Disability rates are based upon table 8.פ of the pension circular 2007-3-6 of the Ministry of Finance. This is a change from prior valuation, which used pension circular 2000/1. The impact is negligible.
   iii) Based on the company leave rate experience as provided to us, we have assumed leave rates dependent on length of service differentiating between with entitlement to full severance pay ("With" column) and without severance pay, as follows. A leave without severance pay means that to the employee receives his accrued savings balance only irrespective of whether the severance pay liability is higher or lower than the savings balance[55].

Year of Service	With	Without
0	20.66%	27.00%
1	12.42%	10.34%
2	9.10%	6.27%
3	6.15%	6.05%
4	4.97%	4.24%
5+	2.00%	2.00%

   iv) Vacation day utilization - based upon the company experience, we expect that future accruals will be positive, ie the employee will use the current accrued days only in the event of leaving the company's employ.

   v) Retirement Age: as per the new pension law[56], based on the employee's date of birth and gender, the retirement age increases from 65 to 67 for men and from 60 to 64 for women.

b) In view of the limited number of years experience currently available, these assumptions were felt to be reasonable, although the credibility of these assumptions is quite limited. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

c) The calculations are based on the following financial assumptions:

[54] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf.
[55] There appears to be a consistent gain on leaves for both severance and vacation liabilities, which should be reviewed carefully to ensure that the company's experience matches that assumed.
[56] חוק גיל פרישה, התשס"ד - 2004

i) The discount rate used is based on the yield of fixed-interest Israeli government bonds[57] with duration equal to the duration of the gross liabilities:

Valuation Date	Severance Duration	Severance Discount Rate	Vacation Duration	Vacation Discount Rate
31/12/2005	18.71	3.89%	16.88	3.86%
31/12/2006	18.87	3.61%	16.50	3.60%
31/12/2007	17.22	3.60%	15.34	3.60%

ii) Salary increase assumptions: 3.0% per annum for senior employees based on management expectations and 5.0% per annum for non-senior employees based on the company's experience and management's confirmation of reasonableness.

iii) The rate of growth of the accrued balance in individual savings plans is assumed to be 3.0% p.a. This reflects 4.0% expected market return after the deduction of 1.0% management fees.

[57] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used Government Bond yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

C5 – Bezeq International

27) Actuarial assumptions

a) The calculations are based on the following demographic assumptions about the future characteristics of current employees who are eligible for benefits:
   i) Mortality rates are based on the recently published Ministry of Finance insurance circular 2007-1-3, which forms the basis for insurance companies reserves for deferred annuity contracts.[58]
   ii) Disability rates are based upon table 8.פ of the pension circular 2007-3-6 of the Ministry of Finance. This is a change from prior valuation, which used pension circular 2000/1. The impact is negligible.

	Staff		Temporary	
Year	**With**	**Without**	**With**	**Without**
1	2.2%	17.6%	3.3%	48.1%
2	9.2%	9.8%	13.9%	11.5%
3	11.7%	9.3%	19.0%	7.5%
4	12.3%	6.4%	26.3%	7.3%
5	11.4%	6.2%	24.7%	6.8%
6	11.0%	4.8%	16.4%	3.0%
7	10.9%	2.0%	9.6%	3.0%
8	10.0%	2.0%	9.8%	3.0%
9	8.0%	2.0%	8.0%	3.0%
10	6.0%	2.0%	6.0%	3.0%
11+	4.0%	2.0%	4.0%	3.0%

   iii) The leave assumed differentiating between with entitlement to full severance pay ("With" column) and without severance pay, based on the experience of the company, is as follows. A leave without severance pay means that to the employee receives his accrued savings balance only irrespective of whether the severance pay liability is higher or lower than the savings balance. In addition we were informed and observed accordingly that the company employs two distinct populations: a core staff of ca. 150 employees and the rest are temporary workers who have a far higher turn-over and a lower salary.

   iv) Vacation Days: The model assumes that employees on average utilize 2 days of accrued vacation (2006 observation).

b) In view of the limited size of the company and the limited number of years experience currently available, these assumptions were felt to be reasonable, although the credibility of these assumptions is quite limited. With the progress of time and the consequent accumulation of experience, these assumptions should be periodically reviewed.

[58] http://www.mof.gov.il/hon/2001/insurance/memos/2007-1-03.pdf.

c) The calculations are based on the following financial assumptions:

i) The discount rate used is based on the yield of fixed-interest Israeli government bonds[59] with duration equal to the duration of the gross liabilities[60]:

Benefit Type	31/12/2006 Discount Rate	31/12/2006 Duration	30/06/2007 Discount Rate	30/06/2007 Duration	30/09/2007 Discount Rate	30/09/2007 Duration	31/12/2007 Discount Rate	31/12/2007 Duration
Severance	3.62%	8.29	3.02%	8.75	3.71%	8.82	3.45%	8.86
Vacation	3.65%	5.19	3.00%	8.05	3.60%	4.11	3.45%	8.86

ii) Salary increase assumptions:

(1) For staff the salary increase is assumed to be 7.0% until age 34, at which point the salary increase decreases each year by 1.0% until it stabilizes at age 40 at 1.0% real salary increase.

(2) For temporary employees, we assumed a flat 1.0% real salary increase for all ages. As the "life" of the severance liability for these type of employees is fairly short, the actual salary increase assumption is less significant.

iii) The rate of growth of the accrued balance in individual savings plans is assumed to be 3.0% p.a. This reflects 4.0% expected market return after the deduction of 1.0% management fees. (See also 3 c).)

[59] Interest rates used are real rates, as the benefits are strongly linked to the inflation - Although IAS 19 recommends the use of market index (IAS 19 §76) yields of high quality corporate bonds (IAS 19 §78), we used Government Bond yields as per our understanding that the local bond market can not really be considered a "deep market" (§78).

[60] Whilst the final valuation date is 31st December 2006, the valuation was performed prior to that date, by estimating the expected situation at that time. As such, the actual discount rates were unknown at the time of the valuation. We have used the valuation rates for 30th November 2006 as the closest available alternative.

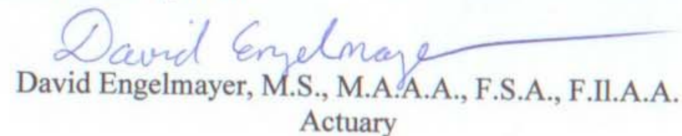
Section D – Results

28) Results

a) The results for the all the companies are as follows (in '000 NIS):

	Net Defined Benefit Obligation				Benefit Expense		
	31/12/2004	**31/12/2005**	**31/12/2006**	**31/12/2007**	**2005**	**2006**	**2007**
Long Term Benefits							
A.1 Vacation Days	80,387.4	83,855.4	90,472.8	83,059.1	23,333.8	31,464.5	21,659.8
A.2 Sick Days	53,032.0	55,955.1	65,429.0	70,036.1	16,421.3	13,618.3	20,856.3
Termination Benefits							
B Early Retirement Total	820,100.0	536,000.0	726,243.1	658,213.6	(120,131.0)	196,959.0	104,944.2
Post Employment Benefits							
C.1 Severance	54,335.4	61,649.3	68,160.1	61,311.1	27,147.3	33,689.2	13,709.2
C.2 Early Notice	0.0	0.0	31,799.4	36,512.2	0.0	31,826.4	13,381.3
C.3 Holiday Gift	51,693.6	58,259.4	51,954.4	47,140.8	9,803.7	(2,785.1)	3,189.3
C.4 Clubs	35,153.6	38,516.2	39,242.5	45,163.4	5,212.6	2,576.3	8,020.9
C.5 Activities	35,446.0	38,985.8	43,455.8	43,680.5	5,467.0	6,439.2	2,574.2
C.6 Early Retirement Seniors				51,796.5			51,796.5
C.7 Full Retirement				2,762.5			2,762.5
Total	**1,130,147.9**	**873,221.2**	**1,116,757.0**	**1,099,675.8**	**(32,745.3)**	**313,787.7**	**242,894.3**

I hereby provide permission to publish this actuarial opinion.



David Engelmayer, M.S., M.A.A.A., F.S.A., F.Il.A.A.
Actuary

Chapter D – Additional Details About the Corporation

Chapter D – Additional Details About the Corporation

1. Summary of the Quarterly Statements of Operations for the Year Ended December 31, 2007 (In NIS millions)

The quarterly financial statements were prepared anew to comply with the International Financial Reporting Standards (IFRS).

	2007	Q 4	Q 3	Q 2	Q 1
Revenues	12,400	3,120	3,139	3,053	3,089
Costs and expenses	10,064	2,607	2,543	2,482	2,432
Operating profit	2,336	513	596	570	657
Financing expenses	309	44	134	73	58
Earnings before Co. equity in affiliates	2,027	469	462	497	599
Equity in affiliates	6	3	1	1	1
Earnings before income tax	2,033	472	463	498	600
Income tax	672	167	132	158	215
Net earnings	1,361	305	330	340	385
Earnings attributed to Co. shareholders	1,330	315	255	361	399
Minority rights in consolidated company	31	(10)	75	(21)	(14)
Net earnings	1,361	305	330	340	385

2. Use of Proceeds from Securities with Reference to the Application of the Proceeds According to a Prospectus

No issue has been made on the basis of a Prospectus.

3. List of Investments in Subsidiaries and Related Companies as at the Balance Sheet Date*

Company name	Name of holder	Class of Share	Number of shares	Total par value	Rate of holding in %	Adjusted cost in NIS millions*	Adjusted balance sheet value in NIS millions*
Pelephone Communications Ltd.	The Company	Ordinary NIS 1	302,460,000	302,460,000	100%	2,133	2,133
Bezeq International Ltd.[1]	The Company	Ordinary NIS 0.1	11,369,900,000	113,699,000	100%	298	298
BezeqCall Ltd.[2]	The Company	Ordinary NIS 0.1	400,000,000	40,000,000	100%	0	0
DBS Satellite Services (1998) Ltd.[3]	The Company	Ordinary NIS 1	14,881	14,881	49.80%	1,044	1,044
Bezeq Online Ltd.[4]	The Company	Ordinary NIS 1	85,000	85,000	100%	24	24
Bezeq Zahav (Holdings) Ltd.[5]	The Company	Ordinary NIS 1	999,999	999,999	100%	956	956
Walla! Communications Ltd.[6]	Bezeq International	Ordinary NIS 1	15,562,759	15,562,759	34.41[7]	80	35

Note: Adanet Business Group Ltd. – Adanet and its subsidiaries are in liquidation/receivership proceedings.

* Stated in accordance with IFRS.

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[1] The merger of the operations of BezeqCall Communications Ltd. into Bezeq International was completed on February 12, 2007.

[2] The company is not active.

[3] D.B.S. Satellite Services (1998) Ltd. includes an investment of NIS 1,044 million which was made by means of loans. Of this, NIS 259 million is in loans linked to the known CPI, NIS 92 million in loans linked to the known CPI and bearing 5.5% interest, and NIS 693 million is in loans linked to the known CPI and bearing 11% interest.

[4] Bezeq *Online* Ltd. includes an investment of NIS 1 million extended as a shareholder loan. The loan is linked to the CPI and is interest-free.

[5] A loan was extended to the subsidiary Bezeq Zahav (Holdings) Ltd. for financing the purchase of Company debentures Series 4 and 5.

[6] Walla! Communications Ltd. includes an investment of NIS 0.5 million which was made by means of shareholders' loans from Bezeq International. The loans are linked to the CPI and are interest-free. During 2007, Bezeq International exercised another 508,874 options in consideration of NIS 0.9 million, which was set off from the balance of those loans. The share price on 31.12.07 – 5.35.

[7] 33.66% fully diluted.

4. Changes in Investments in Subsidiaries and Related Companies During the Report Period

Date of the change	Character of the change	Company name	Reported amounts NIS millions
2.07	Merger of Bezeq International Ltd. and BezeqCall Communications Ltd.	Bezeq International Ltd.	52
2.07	Merger of Bezeq International Ltd. and BezeqCall Communications Ltd.	BezeqCall Communications Ltd.	(52)
5.07	Sale of debentures	Bezeq Zahav (Holdings) Ltd.	(480)
6.07	Sale of debentures	Bezeq Zahav (Holdings) Ltd.	(201)
7.07	Sale of debentures	Bezeq Zahav (Holdings) Ltd.	395
12.07	Linkage differentials	DBS	42
7.07	Update of capital fund at fair IFRS value	DBS Satellite Services (1998) Ltd.	(187)
During 2007	Exercise of option warrants	Walla! Communications Ltd.	There is no transition change between shareholder loans and an investment
12.07	Premium reduction	Bezeq Zahav (Holdings) Ltd.	(60)
12.07	Revaluation	Bezeq Zahav (Holdings) Ltd.	9

5. Revenues of Subsidiaries and Related Companies and Revenues of the Corporation from them as at the Balance Sheet Date (In NIS thousands)

Company name	Earnings (loss) before tax	Earnings (loss) after tax	Dividend	Management Fees	Interest
	NIS millions				
Pelephone Communications Ltd.	800	585	0	0	0
Bezeq International Ltd.	210	153	0	0	0
DBS Satellite Services (1998) Ltd.	(109)	(116)	0	0	89
Bezeq Online Ltd.	2	2	0	0	1
Bezeq Zahav (Holdings) Ltd.	0	0	0	0	66
Walla! Communications Ltd.	20	16	0	0	0

6. Stock Exchange Trading – Listed Securities – Dates and Reasons for Termination of Trading

In 2007 no Company securities were listed for trading.

7. Payments to Senior Officers

Cost of Salary	Total remuneration in NIS thousands
CEO	4,892
Chairman	4,398
Former Deputy CEO	2,250
Deputy CEO	1,309
VP	1,241

8. Salaries and Benefits

1. The salary received by the two external directors complies with the maximum tariffs set in the Companies Regulations (Rules Regarding Remuneration and Expenses for an External Director), 5760 – 2000), pursuant to the index as stipulated in said regulations. In 2007 the salary amounted to NIS 372 thousand.

2. The cost of salary of the former chairman of the board of directors, the former CEO and the current CEO is NIS 10,479 thousand.

   [Including salary and grants for current CEO for the period of his employment as CEO of Bezeq International. Likewise, the conditions of employment of the current chairman of the board have not yet been concluded or approved by the persons authorized for such in the Company. However, the financial statements include a provision in the sum of approximately NIS 4.5 million on the basis of an estimate of salary expenses and future payments].

3. Regarding a management agreement with Ap. Sab. Ar., see Note 29D to the financial statements.

4. The management fee to Ap. Sab. Ar. for 2007 – NIS 5,127 thousand.

9. Shares and Convertible Securities Held by Interested Parties in the Corporation, a Subsidiary or a Related Company, as Close as Possible to the Report Date

	Name of holder	Type of security	Number of convertible securities ratio 1:1	Number of Shares NIS1 n.v. each	Percentage of holding of control and equity	Number of NIS 1 n.v. shares fully diluted	Rate of holdings fully diluted
1.	State of Israel[8]	Ordinary		409,819,914 [9]	15.73%	26,402,256	0.97%
2.	Zeevi Communications Holdings Ltd.[10]	Ordinary		459,331,617	17.63%	459,331,617	16.87%
3.	D.E. Dirot Elite Ltd.	Ordinary		3,097,697	0.12%	3,097,697	0.11%
4.	Ap. Sab. Ar. Holdings Ltd. through Romema Investments Co. Ltd.[11]	Ordinary		781,513,683	30.00%	1,059,211,545	38.89%
5.	Ran Gottfried (director)	Ordinary		12,000	0.00%	12,000	0.00%
6.	Avi Gabbay[12](CEO)	Ordinary	5,250,000	22,600	0.00%	5,272,600	0.19%
7.	Rami Nomkin[13] (director)	Ordinary	93,782		0.00%	93,782	0.00%
8.	Yehuda Porat[14] (director)	Ordinary	42,981		0.00%	42,981	0.00%

10. Registered Capital, Issued Capital and Convertible Securities

Registered capital 2,749,000,000 shares of NIS 1 par value each.

Issued capital 2,605,045,611 shares of NIS 1 par value each, having equal rights.

78,151,368 options to employees for shares of the Company of NIS 1 par value each, in accordance with an outline dated 22.2.07, were allocated on 25.3.07 (including 59,574 options to two directors from the employees, which were allocated on January 2, 2008 in accordance with a private offer report from October 29, 2007).

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[8] In accordance with the agreement between Ap.Sb.Ar Holdings Ltd. and the State for the purchase of the State's holdings in the Company, Ap.Sb.Ar Holdings Ltd. has an option to purchase up to 277,697,862 shares in the Company (which constitute approximately 10.66% of the Company's share capital), which can be exercised until the first business day occurring 48 months after October 11, 2005 (the date of closing the purchase of the Company's shares). Under the aforesaid agreement, Ap.Sb.Ar. Holdings Ltd. will be entitled to request that the State vote with it (within the limits defined in the agreement concerning certain matters) for 10.66% of the Company's shares held by the State and for which Ap.Sb.Ar. Holdings Ltd. received an option to purchase, and for 1.01% of the Company's shares which will remain in the State's hands in the period commencing on October 11, 2005 (the date of closing the transaction) and ending at the end of the option exercise period as aforesaid, and for 4.71% of the Company's shares held by the State, which are designated for allotment to Company employees – for a period as aforesaid or until the transfer of ownership of those shares to Company employees, the earlier of the two. (Note that as at March 6, 2008, the employees have exercised an option for shares in the scope of 0.65%).

[9] This is a reduction as a result of exercise of the options issued to employees of the Company. The rate of the transaction is the exercise price of the option as prescribed in the outline of November 17, 2005

[10] On November 12, 2002, a receiver was appointed to this company, Adv. Alex Hartman, who is authorized to exercise the rights in respect of the Company's shares in accordance with the ruling and approval of the court. It should be noted that this company belongs to the Zeevi Group. Another company of the same group, D.E. Dirot Elite Ltd., (as specified in Section 3) also holds shares in the Company.

[11] See Note 9 above.

[12] On February 4, 2008, 5,250,000 options were allotted to the CEO in accordance with the private placement report of December 25, 2007.

[13] Options allotted to the director from among the employees according to an outline dated 15.11.05 and under an outline for employees dated 22.2.07, subject to the approval of the general meeting which took place on 26.12.07.

[14] Options allotted to the director from among the employees according to an outline dated 15.11.05 and under an outline for employees dated 22.2.07, subject to the approval of the general meeting which took place on 26.12.07.

40,100,000 options to employees for shares of the Company of NIS 1 par value each, in accordance with an outline dated 25.12.07 (out of 65,000,000 option warrants which the Company set aside for exercise of up to 65,000,000 shares of the Company), in accordance with the option plan for managers and senior employees (2007) of which 5,250,000 were to the CEO of the Company as set out in the substantial private placement report of that date.

There are no dormant shares.

11. Registered Address of the Corporation

Address: 132 Menahem Begin Street, Azrieli Center (The Triangular Tower), Tel Aviv.

Telephone 1: 03-6262200; Telephone 2: 03-6262201; Fax: 03-6262209

Email: linoryo@bezeq.co.il (Company Secretary)

12. Directors of the Corporation

A. (1) Name**: Shlomo Rodav** No. ID no. 030596860

(2) Date of Birth: 27/10/1949

(3) Address: 5 Kerem Hazeitim St., Savion

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Chairman of the Security Committee.

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: Yes

The director is Chairman of the Board of Directors (as of September 4, 2007).

(8) Date of start of tenure as a director: 04/09/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA (Economics), Tel Aviv University.

MBA, Columbia University.

2004-2005 – chairman of the board of directors and CEO of Gilat Satellite Networks Ltd.

1990-2007 – CEO, 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.

Member of the board of:

Bezeq International Ltd.

Pelephone Communications Ltd.

DBS Satellite Services (1998) Ltd.

Bezeq Online Ltd.

Walla! Communications Ltd.

Bezeq Zahav (Holdings) Ltd.

(10) Related to an interested party in the Corporation: No

(11) The Company considers the director to have accounting and financial expertise.

B. (1) Name: **Adam Chesnoff*** ID no. 022113597.

(2) Date of Birth: 15/11/1965

(3) Address: 10100 Santa Monica Blvd. Los Angeles, California 90067, U.S.A

(4) Citizenship: Israeli and American

(5) Membership of Board of Directors Committees:

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party:
Is a director of SCG Israel Ventures LLC, which holds 45% of the capital and 40.5% of the voting rights in Ap. Sab. Ar. Holdings Ltd. Ap. Sab. Ar. Holdings Ltd. holds 30% of the share capital of the Company (which is held in trust by Romema Investment Company Ltd.), and he has an option to purchase another 10.7%. Holds 2% of SCG Israel Ventures LLC.

(8) Date of start of tenure as director: 19/09/2007
Acted in the past as director of the company between 11.10.05-4.9.07.

(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics and Management, Tel Aviv University
MBA, School of Business, UCLA
Since 2001, President of Saban Capital Group.
Director of:
Prosieben SAT 1 Media A6 (Germany) – resigned in March 2007.
KSF Corp. (inc. in Delaware, USA).
Broadcast Media Partners, Inc. (inc. in Delaware, USA).
Broadcast Media Partners Holdings (inc. in Delaware, USA).
Univision Communications (inc. in Delaware, USA).
Saban Music Group Inc. (inc. in California, USA).
Far East Innovative Investment B.V. (inc. in the Netherlands).

(10) Related to an interested party in the Corporation: No

(11) The Company views the director as having accounting and finance expertise.

* Adam Chesnoff holds 2.025% of SCG Israel Ventures LLC.

SCG Israel Ventures LLC holds 45% of the capital and 40.5% of the voting rights in Ap. Sab. Ar. Holdings Ltd. Ap. Sab. Ar. Holdings Ltd. holds 30% of the share capital of the Company (which is held in trust by Romema Investment Company Ltd.), and he has an option to purchase another 10.7%.

C. (1) Name: **Zehavit Cohen** ID no. 058344797.

(2) Date of Birth: 16/11/1963

(3) Address: 4 Berkowitz St., Museum Tower, Tel-Aviv.

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Member of Audit Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: CEO of Apax Partners Israel Ltd.

(8) Date of start of tenure as a director: 21/06/2006

(9) Education and employment during the past five years and details of the corporations in which she serves as director:
BA Accounting, Duquesne University
MA Finance - University of Pittsburgh
MA ABD Accounting, University of Pennsylvania
From 1998 – Lecturer in Finance and Accounting, University of Pennsylvania
From 1998 – Deputy CEO and Chief Financial Officer, IDB Development Company Ltd.
From 2003 - Chief Financial Officer, IDB Holdings Company Ltd.
From 1998 – Deputy CEO and Chief Financial Officer, IDB Holdings Company Ltd.
From 2006 – CEO, Apax Israel

(10) Related to an interested party in the Corporation: No

(11) The Company views the director as having accounting and finance expertise.

D. (1) Name: **David Gilboa** ID no. 51212587.

(2) Date of Birth: 02/05/1952

(3) Address: 9 Nahar Yarden St., Kiryat Ono

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Balance Sheet Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: No

Accountant and Adviser of Moshe Arkin

(8) Date of start of tenure as a director: 19/09/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA (Economics & Accounting), Tel Aviv University.

2000-present: senior partner / manager – Chaikin, Cohen, Rubin and Gilboa, Certified Public Accountants.

Director of:

Bezeq International Ltd.

Bezeq Online Ltd.

David Gilboa & Co., Accountants

Gadad Consultancy and Investments (2006) Ltd.

(10) Related to an interested party in the Corporation: No

The Company views the director as having accounting and finance expertise.

E. (1) Name: **Ran Gottfried** ID no. 006357206.

(2) Date of Birth: 20/08/1944

(3) Address: 64 Pinkas Street, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Audit Committee, Security Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: No

(8) Date of start of tenure as director: 24/11/2005

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

Completed two years undergraduate degree studies in Economics and Social Sciences at Tel Aviv University.

From November 2005 – independent adviser at Magnolia Silver Jewelry and Magnolia Export Logistics Ltd.

2001-November 2005 Chairman of the Board of Magnolia Silver Jewelry Ltd.

2003-November 2005 CEO and partner, Magnolia Export Logistics Ltd.

From 2004 to the present – independent adviser at Careline-Neca

From 2000 to the present – independent adviser – strategic consultation to retail companies in Israel and abroad

2000-2002 – Strategic advice to cosmetic companies abroad.

1998-2000 – CEO and partner of NewPharm.

1995-2000 – CEO and partner of April Ltd.

Director of:

2003-2005 Director of Agis

Since 2006 Director of Frigo

(10) Related to an interested party in the Corporation: No

F. (1) Name: **Michael Grabiner** Passport No.: 800111117

(2) Date of Birth: 21/08/1950

(3) Address: 35 Uphill Rd., London NW7 4RA, UK

(4) Citizenship: British

(5) Membership of Board of Directors Committees: No

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: Partner in Apax Partners LLP.

(8) Date of start of tenure as a director: 21/06/2006

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

MA Economics and Politics, Cambridge University.

From February 2002, Partner, Apax Partners LLP

Director of:

Partnerships for Schools Ltd

Synetrix Holding Ltd

Pelephone Communications Ltd

Bezeq International Ltd

Ap. Sab. Ar. Cayman Ltd.

(10) Related to an interested party in the Corporation: Brother of director Steven Grabiner

G. (1) Name: **Steven Grabiner** Passport number: 024558479

(2) Date of Birth: 30/09/1958

(3) Address: 33 Jermyn St., London SW1Y 6DN, UK

(4) Citizenship: British

(5) Membership of Board of Directors Committees: No

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party:

Partner of Apax Partners Worldwide LLP, and head of Media Sector at Apax.

Acted as a director of the Company in the past, between 11.10.05 and 8.3.06, and acted several times as an alternate director.

(8) Date of start of tenure as a director: 04/09/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

MBA, Manchester University.

Director of:

Apax Partners Europe Managers Ltd

Apax Partners Worldwide LLP

Cloverhawk Ltd

(ISC (International Sportsworld Communicators

Jewish Chronicle Limited

Ap. Sab. Ar. Holdings Ltd

Yellow Green Finance & Investment Ltd

Purple Green Project & Investment Ltd

(10) Related to an interested party in the Corporation: Brother of director Michael Grabiner

H. (1) Name: **Itzhak Idelman** ID no. 50066174.

(2) Date of Birth: 01/07/1950

(3) Address: 4 Duchifat St., Tel Mond.

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Audit Committee, Balance Sheet Committee

(6) External Director: Yes.

(7) Employee of the corporation, a subsidiary, related company or interested party: No

(8) Date of start of tenure as director: 01/02/2008

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA (Accounting and Economics), Tel Aviv University.

2005-2007 – Deputy CEO and VP Finances at Ness Technologies Ltd.

1996-2005 – Director of Finance Division at Cellcom.

Director of:

(10) Related to an interested party in the Corporation: No

(11) The Company views the director as having accounting and finance expertise.

I. (1) Name: **Menahem Inbar*** No. ID no. 000483982

(2) Date of Birth: 03/09/1948

(3) Address: 5 Hagilad St., Ramat Gan

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Remuneration, Organization and Administration Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party:

The Director assists Moshe Arkin, an interested party in the Company, with management of his investments.

(8) Date of start of tenure as director: 11/10/2005

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA Social Sciences, Bar Ilan University.

MA Law, Bar Ilan University.

Since 2000 – managing partner at Schifman-Inbar Ltd.

Director of:

DBS Satellite Services (1998) Ltd.

Pelephone Communications Ltd.

Elrov Israel Ltd.

Arkin Communications Ltd.

Schifman-Inbar Ltd.

Mobile Solid Ltd.

Carmel Investment Group Ltd.

Sphera Global Healthcare

(10) Related to an interested party in the Corporation: No

(11) The Company views the director as having accounting and finance expertise.

* The director holds 3% of the shares of Arkin Communications Ltd.

J. (1) Name: **Kihara R. Kiarie** Passport number: 039101782

(2) Date of Birth: 16/05/1974

(3) Address: 10100 Santa Monica Blvd. Los Angeles, California 90067, U.S.A

(4) Citizenship: American

(5) Membership of Board of Directors Committees: Balance Sheet Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: Is an officer (director) of Saban Capital Group, a company which has indirect holdings in Ap. Sab. Ar. Holdings Ltd.

(8) Date of start of tenure as director: 24/11/2005

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

B.Ec., Dartmouth College.

MBA, Harvard Business School.

2003-2006 – Saban Capital Group (Director).

1999-2001 – Associate at AEA Investors.

Director of:

Saban Capital Group

(10) Related to an interested party in the Corporation: No

K. (1) Name: **Rami Nomkin** ID no. 042642306.

(2) Date of Birth: 14/01/1949

(3) Address: 126 Moholiver Street, Yahud

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Balance Sheet Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: The director is IP Center Manager in the Business Division.

(8) Date of start of tenure as director: 17/01/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

High School Education

From 2007 - manager of Bezeq's IP center.

From 2001 – Business Center Manager at Bezeq Business

Until October 11, 2005 served as employee-director.

Director of other corporation: No

(10) Related to an interested party in the Corporation: No

L. (1) Name: **Yehuda Porat** No. ID no. 059769455

(2) Date of Birth: 18/02/1968

(3) Address: 2 Mevo Haro'im, Har Adar 90836

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: (Observer on Security Committee pending amendment of articles of association and license).

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: Manager of the Security, Safety and Emergency Department of the Company.

(8) Date of start of tenure as director: 17/01/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

LL.B., 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 – General Security Services

Interrogation course – General Security Services

Directors in Private and Public Companies course- The Israeli Center for Management

Advanced Directors course - The Israeli Center for Management

Analysis of Financial Reports and Corporate Value Assessment course - The Israeli Center for Management

Qualified Mediator course – Israel Bar Association

From 1999 - Manager of Bezeq's Bugging Detection and Special Jobs Department

Until October 11, 2005 served as employee-director

(10) Director of other corporation: No

(11) Related to an interested party in the Corporation: No

M. (1) Name: **Yoav Rubinstein** No. Identity no. 16447153

(2) Date of Birth: 17/05/1973

(3) Address: Apartment 28, 2 Kehilat Venezia Street, Tel Aviv

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Chairman of Remuneration and Organization Committee, Balance Sheet Committee, Committee to Negotiate with Former CEO.

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: The director is investment manager of Apax Israel Investment Fund.

(8) Date of start of tenure as a director: 21/06/2006

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA Business Administration, Interdisciplinary Center

From 2000 - Investment Manager, Apax Partners

Director of:

DBS Satellite Services (1998) Ltd.

Walla! Communications Ltd.

Yellow Green Finance & Investment Ltd

Purple Green Project & Investment Ltd

Ap. Sab. Ar. Holdings Ltd.

Ap. Sab. Ar. Cayman Ltd.

Genetrix

(10) Related to an interested party in the Corporation: No

(11) The Company considers the director to have accounting and financial expertise.

N. **(**1) Name: **Arieh Saban** ID no. 064902083.

(2) Date of Birth: 02/05/1947

(3) Address: 59 Kaplan Street, Herzliya

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: No

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: No

(8) Date of start of tenure as director: 11/10/2005

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

From 2001 – partner in the Fox Kids Channel. He sold all his holdings in December 2002.

For 15 years distributed and marketed children's television programs through Israel Audio Visual Corp.

Director of:

Bezeq International Ltd.

Pelephone Communications Ltd.

Keshet Broadcasting Ltd.

(10) Related to an interested party in the Corporation: Yes

Brother of Haim Saban. Haim Saban is the controlling shareholder of SCG Israel Ventures LLC, which holds 45% of the capital and 40.5% of the voting rights in Ap. Sab. Ar. Holdings Ltd. Ap. Sab. Ar. Holdings Ltd. holds 30% of the share capital of the Company (which is held in trust by Romema Investment Company Ltd.).

O. (1) Name: **Elon Shalev** ID no. 050705276.

(2) Date of Birth: 26/07/1951

(3) Address: 70 Yehoshua Bin Nun Street, Tel Aviv.

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Audit Committee, Remunerations Organization & Administration Committee

(6) External Director: No

(7) Employee of the corporation, a subsidiary, related company or interested party: No

The director provides services to KSF Corp., which is a company indirectly controlled by Haim Saban.

Acted as a director of the Company in the past, between 11.10.05 and 8.3.06, and acted several times as an alternate director.

(8) Date of start of tenure as a director: 04/09/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA Political Science, Tel Aviv University.

Entrepreneur and Consultant

Director of:

Bezeq International Ltd.

DBS Satellite Services (1998) Ltd.

Shachal Medical Services Ltd. and its subsidiaries.

Logia Group Ltd. and its subsidiaries.

(10) Related to an interested party in the Corporation: No

P. (1) Name: **Dr. Eyal Yaniv** ID no. 05640644.

(2) Date of Birth: 21/06/1960

(3) Address: 38 Hakinor St., Petach Tikva

(4) Citizenship: Israeli

(5) Membership of Board of Directors Committees: Chairman of Audit Committee, Security Committee, Remunerations, Organization and Administration Committee.

(6) External Director: Yes. Has financial and accounting expertise.

(7) Employee of the corporation, a subsidiary, related company or interested party: No

(8) Date of start of tenure as director: 01/02/2007

(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA Psychology and Computer Science, Bar Ilan University.

MA Psychology, Bar Ilan University.

Ph.D. Business Administration, Bar Ilan University.

LL.M., Ono Academic College.

Until 2002, CEO of Non-Stop.

From 2002 – Strategic Marketing Adviser and Personal Management Coach

From 2003 – Head of Executive MBA Program and lecturer in Business Administration (Strategy, Enterprise and Marketing) at Bar Ilan University and at Hebrew University.

Director of other corporation: No

(10) Related to an interested party in the Corporation: No

13. Senior Officers of the Corporation

A. (1) Name: **Avi Gabbay** ID no. 59777920

(2) Date of Birth: 22/02/1967

(3) Date of Commencement of Office: 14/11/2007

(4) Position in the Company: CEO

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

Education and business experience over the past five years:

MBA, Hebrew University

6/07-11/07 – Acting CEO of Bezeq, The Israel Telecommunications Corp. Ltd.

7/03-6/07 – CEO Bezeq International

11/00-6/03 – VP Economics and Strategy

B. (1) Name: **Alan Gelman** ID no. 015704307

(2) Date of Birth: 05/11/1955

(3) Date of Commencement of Office: 15/02/2008

(4) Position in the Company: CFO and Deputy CEO

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

Pelephone Communications Ltd.

Walla! Communications Ltd.

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years:

B A., Queens College, NY

MBA, Hofstra University, NY

Certified Public Accountant in Israel.
CPA in the State of NY
2007 – CFO and Deputy CEO of Delek Group.
2001-2006 – CFO at Partner Communications Ltd.

C. (1) Name: **Eliezer Mizroch** ID no. 025045139
(2) Date of Birth: 01/02/1973
(3) Date of Commencement of Office: 01/10/2006
(4) Position in the Company: Deputy CEO – Strategy and Business Development
Position in a subsidiary of the Company, in a related company or in an interested party of the Company:
Director of:
Bezeq Online Ltd.
DBS Satellite Services (1998) Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Business Administration, Cape Town University, South Africa
1999-2002 – Manager of Strategy Department, Retail Division, Bank Hapoalim.
2003-2005 – Manager of Strategic Management Center, Bank Hapoalim.
Since 2005 – Manager of Marketing and Strategic Planning Department, Retail Division, Bank Hapoalim.

D. (1) Name: **Bosmat Chelouche** ID no. 052592664
(2) Date of Birth: 08/05/1954
(3) Date of taking office: Since September 1, 1998, General Counsel, and since November 16, 2005 also as VP.
(4) Position in the Company: VP, General Counsel
Position in a subsidiary of the Company, in a related company or in an interested party of the Company:
Director of:
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
LLB, Tel Aviv University.
LLM, Commercial Law, Tel Aviv University
1998-2007 – General Counsel of Bezeq (since 16.11.05, also acting as VP).

E. (1) Name: **Malka Dror** ID no. 056524358
(2) Date of Birth: 07/07/1960
(3) Date of Commencement of Office: 28/06/2007
(4) Position in the Company: Chief Internal Auditor
Position in a subsidiary of the Company, in a related company or in an interested party of the Company:
Director of:
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years
BA Economics, Hebrew University
CISA qualification for the position of Controller of Computer Systems
Course in auditing and information systems security
Course in information systems analysis
6/07-8/06 acting internal auditor
12/04-8/06 - Manager, Audit Department and Deputy Internal Auditor – Bezeq.
1995-2004 – Department Manager, Bezeq.

F. (1) Name: **Sharon Fleischer Ben Yehuda** ID no. 028531648

(2) Date of Birth: 25/04/1971

(3) Date of Commencement of Office: 01/06/2006

(4) Position in the Company: VP Regulation

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

BA Political Science, Hebrew University, Jerusalem

MA Public Policy and Administration, Hebrew University, Jerusalem.

Until 31.5.06 – VP Regulation at Pelephone Communications Ltd.

2001-2005 – Manager, Regulation and Government Relations Department, Pelephone Communications Ltd.

1995-2001 – Senior Adviser to Director General at Ministry of Communications.

G. (1) Name: **Eli Frank** ID no. 053337739

(2) Date of Birth: 06/07/1955

(3) Date of Commencement of Office: 19/09/2006[15]

(4) Position in the Company: VP Information Systems

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

MBA, Tel Aviv University

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)

12/03-6/04 – VP and Department Manager Ness Information Technology Services Group

1999-2003 –VP CRM Systems Supply and Billing Division, Amdocs

H. (1) Name: **Ran Guron** ID no. 024113268

(2) Date of Birth: 25/12/1968

(3) Date of Commencement of Office: 09/01/2006

(4) Position in the Company: VP Marketing

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

BA Economics and Business Administration, Hebrew University

MBA, Hebrew University

2003-2005 VP Marketing, Barak

1997-2002 VP Marketing Business Sector, Cellcom

I. (1) Name: **Itamar Harel** ID no. 028054666

(2) Date of Birth: 18/10/1970

(3) Date of Commencement of Office: 25/10/2007

(4) Position in the Company: VP, Manager of Private Division

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

BA Economics and Business Administration, Hebrew University

2002-2007 – Manager of Private Marketing Department and Manager of Private and Medium and Small Business Sales and Services Department at Bezeq

J. (1) Name: **Eyal Kamil** ID no. 057248999

(2) Date of Birth: 30/08/1961

(3) Date of Commencement of Office: 05/12/06

(4) Position in the Company: VP Operations & Logistics

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any 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 – 4.12.06 – Manager, Change Administration, Bezeq.

2001-2005 – Manager, Organization and Methods Department, Pelephone Communications Ltd.

K. (1) Name: **Yuval Keinan** ID no. 032089245

(2) Date of Birth: 23/02/1975

(3) Date of Commencement of Office: 01/08/07

(4) Position in the Company: VP Engineering and Networks Division

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any 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.

L. (1) Name: **Ehud Mezuman** ID no. 052176336

(2) Date of Birth: 17/02/1954

(3) Date of Commencement of Office: 25/10/2007

(4) Position in the Company: VP Human Resources

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) 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.

M. (1) Name**: Dudu Mizrachi** ID no. 024810368

(2) Date of Birth: 28/01/1970

(3) Date of Commencement of Office: 28/06/2007

(4) Position in the Company: VP Economics & Budgets

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

BA Economics, Hebrew University

2000-2007 – Director of Regulations Department at Bezeq.

N. (1) Name: **Danny Oz** ID no. 054299953

(2) Date of Birth: 16/06/56

(3) Date of Commencement of Office: 01/09/98

(4) Position in the Company: Accountant and Deputy CFO.

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any 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

O. (1) Name: **Yaakov Paz** ID no. 058610999

(2) Date of Birth: 21/10/1963

3) Date of Commencement of Office: 01/11/2007

(4) Position in the Company: VP, Manager of Business Division

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

Since 2006 – Chairman of board of directors of Alcatel

2006 – CEO, DoubleU Advanced Mobile Solutions

2002-2006 – CEO and Chairman of Alcatel Telecom Israel Ltd.

P. (1) Name: **Linor Yochelman** ID no. 032037939

(2) Date of Birth: 11/02/1975

(3) Date of Commencement of Office: 19/08/2007

(4) Position in the Company: Company Secretary

Position in a subsidiary of the Company, in a related company or in an interested party of the Company:

Company secretary of subsidiaries: Bezeq International Ltd.; Bezeq Online Ltd.; Bezeq Zahav Holdings Ltd.

Director of:

(5) Related to a senior officer or to any interested party: No

(6) Education and business experience over the past five years

BA Business Administration, Interdisciplinary Center, Herzliya

LLB, Interdisciplinary Center, Herzliya.

2005-2007 Company secretary of The Phoenix Holdings Ltd.; The Phoenix Insurance Company Ltd.; and The Phoenix Investments & Finances Ltd.

2002-2005 – Assistant to Chief Judge of the Local Court, Tel Aviv.

Following are the names of the senior officers who completed their term of service during the course of 2007 and by the date of publication of the periodic report for 2007:

Directors:

Blanche Kay – completed her tenure as external director on January 26, 2007.

Yigal Cohen Orgad – completed his tenure as external director on January 26, 2007.

David Blumberg – completed his tenure on February 1, 2008.

Pinchas Barel Buchris – completed his tenure on April 5, 2007.

Moshe Arkin – completed his tenure on June 26, 2007.

Dov Weisglass – completed his tenure on September 4, 2007.

Tomer Guriel – completed his tenure on September 4, 2007.

Senior officers who are not directors:

Shay Ben Yakar – completed his tenure as Acting CFO on January 31, 2007.

Erez Hasdai – completed his tenure as Acting VP Economics on January 31, 2007.

Ran Oz – completed his tenure as Deputy CEO and CFO on February 15, 2008.

Yacov Gelbard – completed his tenure as CEO of Bezeq on April 30, 2007.

Yitzhak (Ika) Abravanel – completed his tenure on June 26, 2007.

Michel Hibert – completed his tenure on August 1, 2007.

Yuval Rachlevsky – completed his tenure as VP Human Resources on November 30, 2007.

Nissim Alafia – completed his tenure as VP Business Division on November 30, 2007.

Einat Rom – completed her tenure on December 31, 2007.

14. The Auditors of the Corporation

Somech Chaikin – Certified Public Accountants (Isr.)

Address: 17 Ha'Arba'a Street

Millennium Tower KPMG

Tel Aviv 64739

Tel: 03-6848000

15. Change in the Memorandum or Articles of Association

On February 1, 2007 the registered capital was increased by 124,000,000 ordinary shares. The Company's Memorandum and Articles were amended accordingly.

16. Recommendations and Resolutions of the Directors Before the General Meeting and their Resolutions which are not Subject to the Approval of the General Meeting

16.1 December 26, 2006 – to recommend to the General Meeting to increase the registered capital of the Company by 124,000,000 ordinary shares of NIS 1 par value each, which shall have rights equal to those of the Company's ordinary shares of NIS 1 par value.

16.2 August 13, 2007 – 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 760 million, constituting NIS 0.2917415 per share and 29.17415% of the issued and paid-up share capital of the Company. The rate of the dividend that shall actually be paid shall be determined in accordance with the issued and paid-up share capital of the Company.

16.3 November 14, 2007 – to convene a general meeting of the shareholders of the Company to ratify the resolutions on the agenda of the meeting of September 19, 2007; to approve a contract with Clal regarding an officers' liability insurance policy, and to approve the award of a deed of indemnity to directors and officers.

16.4 November 20, 2007 – to recommend that the general meeting approve the option plan for senior employees and officers of the Bezeq Group.

16.5 December 24, 2007 – to recommend that the general meeting appoint Mr. Itzhak Idelman as external director of the Company, approve his salary and grant a deed of undertaking to indemnify in advance.

17. Resolutions of a Special General Meeting

17.1 Election of Rami Nomkin and Yehuda Porat as employee directors (resolution of January 17, 2007).

17.2 Approval of grant of advance indemnity undertaking for officers of the Company (resolution of January 17, 2007) for any liability or expense that may be imposed upon the officer due to acting by virtue of being an officer of the Company, including acts done in subsidiaries. The total sum of the indemnity was limited to a ceiling of 25% of the Company's equity as may be at the time of giving of the indemnity. The deed of indemnity applies to a list of classes of events set out in the schedule to the deed of indemnity.

17.3 Election of David Blumberg & Eyal Yaniv as external directors for a period of three years (resolution of February 1, 2007).

17.4 Approval of conditions of office of external directors in accordance with the maximum tariffs set out in the Companies (Rules Regarding Remuneration of External Director) Regulations, 5760-2000, and advance indemnity undertaking (resolution of February 1, 2007).

17.5 Approval of increase of the registered capital of the Company by 124,000,000 ordinary shares of NIS 1 par value each, and amendment of the memorandum and articles of association of the Company accordingly (resolution of February 1, 2007).

17.6 Approval of allocation of options and shares flowing from exercise thereof to employees of the Company and to senior management of the Group in the sum of 5.5% of the issued capital of the Company (143,277,509 options exercisable for 143,277,509 ordinary shares of NIS 1 par value each) (resolution of February 1, 2007).

17.7 Approval, pursuant to the recommendations of the board of directors of the Company, the payment to shareholders of the Company of a cash dividend in the total sum of NIS 760 million, constituting NIS 0.2917415 per share and 29.17415% of the issued and paid-up share capital of the Company. (resolution of September 9, 2007 and ratification of December 26, 2007).

17.8 Election of David Gilboa, CPA (Isr.) as director of the Company (resolution of September 19, 2007, and ratification of December 26, 2007).

17.9 Approval of the issue of options to employee directors (as part of their entitlement to options as employees of the Company) in accordance with a private offer under the option scheme for all employees of the Company published in an outline of February 22, 2007, as follows:

(1) To Mr. Rami Nomkin - 39,862 options.

(2) To Mr. Yehuda Porat - 19,712 options.

(resolution of December 26, 2007).

17.10 Approval of one-time retirement grant to former chairman of the board of directors Mr. Dov Weisglass, in the sum of NIS 1.5 million (resolution of December 26, 2007).

17.11 Grant of an undertaking to indemnify pursuant to the deed of indemnity the form of which was approved by the board of directors on November 27, 2006 and by the general meeting of shareholders on January 17, 2007 and which is given to all officers of the Company for any liability or expense imposed upon the officer as a result of his activities by virtue of being an officer of the Company (including activities in subsidiaries), under the restrictions set out in the Companies Law. The sum of the indemnity is restricted to a ceiling of 25% of the shareholders' equity of the Company as at the time of actual grant of the indemnity (with respect to all of the officers of the Company). The deed of indemnity applies to a list of classes of events attached to the deed of indemnity.

17.12 The officers in respect of which the grant of the indemnity undertaking was approved are: the chairman of the board of directors – Shlomo Rodev, directors – Steven Grabiner, Alon Shalev and David Gilboa, Acting CEO – Avi Gabbay, VP Economics and Budget – David Mizrachi, VP Engineering and Networks – Yuval Keinan, VP Business Division – Yaakov Paz, VP Private Division – Itamar Harel, VP Human Resources – Ehud Mezuman and Company Secretary – Linor Yuchelman (resolution of December 26, 2007).

17.13 Approval of purchase of insurance policies to cover liability of officers of the Company for a period of one year from October 11, 2007 with a liability ceiling of up to $ 150 million per claim and total for the entire insurance year. In addition, up to $ 30 million per claim and for total claims for the insurance period for legal expenses in Israel alone. Liability ceiling for subsidiaries – up to $ 50 million (as part of the aforesaid liability ceiling). Annual premium of up to $ 510,000 (resolution of December 26, 2007).

17.14 Approval of "framework agreement" for the company's contracting in the ordinary course of its business in future insurance policies (following expiry of the current policy set out in sub-section (1) above) to cover the liability of directors and officers, as may be applicable from time to time, including directors and officers of companies in which the Company holds more than 50%, officers acting for the Company in companies in which the Company holds 20% or more and senior employees who are not officers regarding administrative acts done by them all via a "framework transaction" as defined in the Companies (Relief in Transactions with Interested Parties) Regulations, 5760-2000, at an annual premium in the sum of up to $ 510,000 plus a sum of up to 20% of the aforesaid premium for the sum of the current insurance premium (and set out in sub-section (1) above) (resolution of December 26, 2007).

17.15 Approval of issue of options (and shares flowing from exercise thereof) to senior management of the Group in accordance with the option plan under which up to

65,000,000 options, exercisable for 65,000,000 ordinary shares of NIS 1 par value each, constituting approximately 2.5% of the issued share capital of the Company (approximately 2.36% under full dilution) shall be issued, as follows:

A. Issue of up to 41,350,000 options (and shares flowing from exercise thereof) exercisable for 41,350,000 ordinary shares of NIS 1 par value each to offerees in accordance with the outline published by the Company on December 25, 2007 and to the CEO of the Company under a private placement published by the Company on the same date.

B. Issue of the balance of the options in the plan included in the reserve under the plan (and the shares flowing from exercise thereof), and re-issue of all of the options issued under sub-section (A) above, which shall be included in the future in the reserve if not exercised (resolution of January 30, 2008).

17.16 Approval of appointment and conditions of office of Mr. Itzhak Idelman as external director for a period of three years (resolution of January 31, 2008).

18. Transactions Requiring Special Approvals

18.1 On May 22, 2007

The board of directors, having received the consent of the Audit Committee in its meetings of May 15, 2007 and May 22, 2007, approved the award of grants to the following office-bearers as follows, which, in the opinion of the board of directors, constituted extraordinary transactions:

(1) Ika Abravanel - Deputy CEO (Acting CEO). The sum of NIS 768,000, constituting 80% of the salary in fact paid to him in 2006.

(2) Ron Eilon – Deputy CEO and Chief Financial Officer from October 11, 2005 until August 28, 2006. The sum of NIS 640,000, constituting 80% of the salary in fact paid to him for 2006 for the period of his employment by the Company.

(3) Yuval Rachlevsky – VP Human Resources since April 1, 2006. Date of commencement of officer's tenure at the Company is April 1, 2006. The sum of NIS 540,000 constituting 80% of the salary in fact paid to him for 2006.

18.2 On June 18, 2007

The board of directors approved the following transactions with YES: Transaction A – debt rescheduling transaction regarding YES usage fees owed to Bezeq since September 2006 (the "rescheduling arrangement"); transaction B – transactions to market the Company's internet services via YES in 2003-2007 (the "marketing arrangements"); transaction C – installment transactions for YES with respect to advertising for 2005-2007 (the "advertising arrangements").

18.3 On July 8, 2007

The board of directors approved, with respect to the raising of new debt by DBS as part of a private placement from institutional investors in the sum of approximately NIS 620 million, that the Company would sign a deed of consent in favor of the banks financing DBS's operations.

With respect to the loan from the Harel Group (in the sum of NIS 100 million), retroactive approval of the Company's consent to provide the loan in favor of DBS, for suborning the shareholders loan to Harel's loan, and the possibility of early repayment of the loan.

18.4 On July 16, 2007

The board of directors approved the conditions of employment of Mr. Avi Gabbay as Acting CEO of the Company.

18.5 On October 25, 2007

The board of directors approved a retirement grant of NIS 1.5 million to Dov Weisglass, former chairman of the board of directors.

19. Valid Insurances and Indemnities

Insurance

A resolution from May 16, 2005 regarding approval of the exercise of an option for the purchase of a run-off policy covering the liability of Company officers by virtue of which a run-off insurance policy was issued covering the liability of officers who served in the Company until the date of transfer of control, October 11, 2005, for a period of seven years from said date.

Resolution from August 3, 2005 regarding the extension of an officers' insurance policy including the run off option, for a period of up to four months.

Resolution of December 26, 2007 regarding approval of purchase of insurance policies to cover liability of officers of the Company for a period of one year from October 11, 2007 with a liability ceiling of up to $ 150 million per claim and total for the entire insurance year. In addition, up to $ 30 million per claim and for total claims for the insurance period for legal expenses in Israel alone. Liability ceiling for subsidiaries – up to $ 50 million (as part of the aforesaid liability ceiling). Annual premium of up to $ 510,000 (resolution of December 26, 2007).

Resolution of December 26, 2007 regarding approval of "framework agreement" for the company's contracting in the ordinary course of its business in future insurance policies (following expiry of the current policy set out in sub-section (1) above) to cover the liability of directors and officers, as may be applicable from time to time, including directors and officers of companies in which the Company holds more than 50%, officers acting for the Company in companies in which the Company holds 20% or more and senior employees who are not officers regarding administrative acts done by them all via a "framework transaction" as defined in the Companies (Relief in Transactions with Interested Parties) Regulations, 5760-2000, at an annual premium in the sum of up to $ 510,000 plus a sum of up to 20% of the aforesaid premium for the sum of the current insurance premium.

Indemnification

A resolution from January 17, 2007 concerning approval of the granting of an undertaking to indemnify in accordance with the Note to an undertaking to indemnify for each Company officer in respect of any liability or expense imposed on him by actions taken in his capacity as a Company officer (including his actions in subsidiaries), is within the limits laid down by the Companies Law. The amount of indemnification is capped at 25% of the Company's share capital as it shall be when the indemnification is granted. The undertaking to indemnify shall apply to a list of types of occurrences which is attached to the Note to an undertaking to indemnify which is attached to the immediate report concerning the convening of a General Meeting to approve the granting of an indemnification commitment. During 2007, grant of indemnification was also approved for new officers who joined the Company.

It should be noted that in the past, the Company granted indemnity to officers in the following areas:

A. An undertaking to indemnify in respect of the issuance under a prospectus from 1998.

B. An undertaking to indemnify for a draft of the prospectus which was submitted to the Securities Authority in 1999.

C. An undertaking to indemnify for Y2K risks.

D. An undertaking to indemnify in respect of an allotment of shares, in everything relating to the framework agreement from January 13, 2002.

E. An advance undertaking to indemnify for any expense or financial liability which is imposed on an officer following a proceeding filed against him in respect of the Company's prospectus from May 2004.

F. An advance undertaking to indemnify Company officers who served in the Company at the time the undertaking to indemnify was made or who were in office during the seven years preceding that date, for any expense or financial liability imposed on an officer due to a claim by a shareholder who held, at any time during the fours years preceding the date on which the undertaking to indemnify was given, 15% and more of the issued share capital of the Company.

G. An undertaking to indemnify to Company officers who served in the Company at the time an undertaking to indemnify was made or who were in office during the seven years preceding that date, to grant a loan for financing reasonable litigation expenses in a proceeding in which an officer is sued by another person, including a derivative action. The loan will become a grant if a competent court does not impose liability on the officer in a rule absolute.

H. An undertaking to indemnify to officers that the insurance cover for events covered by an officers' insurance policy, which the Company purchased in July 2003, will be maintained for seven years, provided that the cost of the insurance premium is reasonable.

I. An undertaking to indemnify from April 6, 2005 for financial liability imposed on Company officers for reasonable litigation expenses incurred by them in all matters pertaining directly or indirectly to a sale of State holdings in the Company.

J. An undertaking from May 16, 2005 to indemnify Company offers who were in office during the seven years preceding the date of completion of the sale in the Company.

____________________	____________________
Date	Bezeq The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Shlomo Rodav – Chairman of the Board

Avi Gabbay, CEO