

November 16, 2005



**"Bezeq" The Israel Telecommunication Corp.
Limited**

Quarterly Report for the period ending 30.9.05

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

**Directors' Report on the State of the Company's Affairs
for the period ended September 30, 2005**

**Condensed Interim Consolidated Financial Statements as at
September 30, 2005**

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

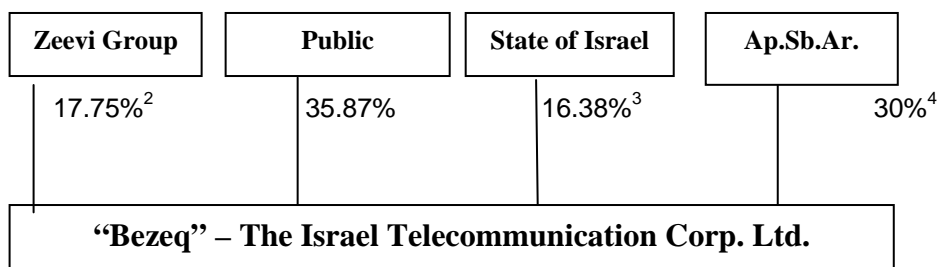
UPDATE OF CHAPTER A (DESCRIPTION OF COMPANY OPERATIONS)¹
TO THE PERIODIC REPORT FOR 2004 ("THE PERIODIC REPORT")
OF "BEZEQ" – THE ISRAEL TELECOMMUNICATIONS CORP. LTD.
(HEREINAFTER: "THE COMPANY")

1. DESCRIPTION OF GENERAL DEVELOPMENT OF GROUP OPERATIONS

Section 1.1 – Group Activity and Description of its Business Development

In the matter of the diagram of the structure of holdings of the Company set out in section 1.1.3 to the Periodic Report – following completion of the sale of 30% of the State's holdings in the Company to Ap.Sb.Ar. Holdings Ltd. ("**Ap.Sb.Ar.**") on October 11, 2005, Ap.Sb.Ar. 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 held by the State. The remainder of the State's holdings after completion of the above sale (prior to exercise of the aforesaid option and prior to exercise of employee profit options as set out in the update to section 2.9 below amounts to 16.38%. For this, and for the voting rights of Ap.Sb.Ar. by virtue of the State's shares in the Company, see section 1.3 below.

The following is an up-to-date diagram of the shareholdings in the Company:



In the matter of section 1.1.5 to the Periodic Report regarding the merger of the Company with DBS Satellite Services (1998) Ltd. (hereinafter: ("**DBS**") – on October 11, 2005, a hearing was held in relation to petitions filed by DBS and the Company in the High Court of Justice, against the jurisdiction of the Minister of Communications to intervene regarding the injection of funds to DBS by its shareholders, including the Company and external entities – the cable companies were joined as respondents to the petitions. As at the date of publication of these reports, the decision of the High Court of Justice has not yet been handed down.

In the matter of the Antitrust Commissioner's conditional approval of the merger and the appeals filed by the Company and DBS – the Company applied to expunge the

¹ The update is pursuant to Article 39A of the Securities Regulations (Periodic and Immediate Reports), 5730-1970, and includes material changes or innovations that have occurred in the corporation in any matter which must be described in the Periodic Report. The update relates to the section numbers used in Chapter A (Description of Company Operations) in the Company's Periodic Report for 2004.

² 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.

³ For the option given to Ap.Sb.Ar. to purchase up to 10.66% of the State's shares, see update to section 1.3 below; for employee options, see update to section 2.9(d) below.

⁴ The shareholders of Ap.Sb.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.

appeal that it filed, *inter alia* for the reason that the condition limiting the injection of funds by the Company into DBS was due to expire. DBS also filed an application to expunge the appeal that it filed, for the same reasons, and on September 19, 2005, the appeals were expunged. The cable companies also filed an appeal against the merger. This appeal is pending following dismissal, on July 25, 2005, of the Company's and DBS's applications to strike it out *in limine*, and has been set down for preliminary hearing on December 1, 2005.

For a detailed description of developments in this matter, see also Note 4 to the financial statements of the Company for the period ended September 30, 2005.

Section 1.3 – Investments in Equity and Stock Transactions

Further to the provisions of sections 1.3.4 and 2.20 to the Periodic Report, regarding the process of privatization of the Company – the State chose Ap.Sb.Ar., which offered NIS 4,237,000,000 for 30% of the share capital of the Company and options to purchase an additional 10.66% of the shares of the Company, as the preferred bidder. Transfer of the State's holdings to Ap.Sb.Ar. required the receipt of consents under all laws, including the consent of the Prime Minister and the Minister of Communications, under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "**Communications Law**") and the Telecommunications (Prescription of Essential Service Provided by Bezeq – the Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the "**Telecommunications Order**"), and the consent of the Antitrust Commissioner under the Antitrust Law, 5748-1988.

Following the "industrial espionage" incident (see in this regard section 2.20(b) below) and disputes that have arisen between the State and Ap.Sb.Ar. regarding the effect of that incident on the Bezeq Group, on July 7, 2005, the Parties reached an agreement regarding various demands made by Ap.Sb.Ar. as conditions of completion of the transaction. Based on a notice from the Government Companies Authority, this agreement has implications on the exercise price of the options received by Ap.Sb.Ar., to the extent that such might relate to and result from the above incident, plus the accrual of interest on the transaction price up to completion of it. For this matter, see the Company's Immediate Reports dated July 10, 2005 and July 14, 2005.

On October 11, 2005, (subsequent to all of the consents required by law having been received) the aforesaid transaction was completed, under which the State sold Ap.Sb.Ar., off the Stock Exchange, 781,513,683 of the shares in the Company held by the State (constituting approximately 30% of the shares in the Company), and options to purchase 277,697,862 shares in the Company held by the State (constituting approximately 10.66% of the shares in the Company), all under the conditions set out in the agreement for sale of the State's holdings in the Company, between the State of Israel and Ap.Sb.Ar. (and parties with an interest in it) dated as above.

In consideration for the shares and options as aforesaid, the total sum of NIS 4,246,286,575 was paid by Ap.Sb.Ar.

Ap.Sb.Ar.'s shares in the Company are to be held in trust by Romema Investment Company Ltd.

According to information provided to the Company:

- a. Pursuant to the agreement with the State, Ap.Sb.Ar. purchased 30% of the State's shares in the Company and an option for the purchase of up to 277,697,862 of the State's shares in the Company (constituting approximately 10.66% of the share capital of the Company), on the conditions set out in the above agreement, as set out in the Company's immediate reports dated July 14, 2005 and October 16, 2005. The option is

exercisable up until the first day of business 48 months after October 11, 2005 (the date of completion of purchase of the Company's shares).

- b. Pursuant to this agreement, Ap.Sb.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.Sb.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 update to section 2.9(d) below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

As a result of completion of the transaction, the Company was released from certain limitations that had been imposed upon it as a company controlled by the State of Israel, including cancellation and/or amendment of some of the provisions of its bylaws, which were similar to certain provisions of the Government Companies Law, 5735-1975. Likewise, the bylaws of the wholly owned subsidiaries of the Company have been amended such that, *inter alia*, the provisions regarding the number of members of the board of directors, proceedings for appointment of them, and provisions regarding the composition of committees of the board of directors were amended, and provisions relating to the Government Companies law (in the bylaws of former government subsidiaries) were deleted. Further to such, the directors of the Company's subsidiaries were replaced such that directors were appointed from the ranks of senior management of the Group, subject to the rules of structural separation in the Group.

Section 1.4 – Distribution of Dividends

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

Agreements in this regard might be obtained with the Workers Organization - in this regard, see section 2.9(d) below.

Section 1.6 – General Environment and Influence of External Factors on Group Operations

The relations between the Company and its subsidiaries are strictly limited, which make it very difficult for the Group to manage the high level of competition in the field of communications. Similar limitations do not apply to entities in competition with the Company. Thus, for instance, on July 7, 2005, an unconditional merger was approved by the Antitrust Commissioner between Discount Investment Company Ltd. ("DIC") and Cellcom Israel Ltd. ("Cellcom"), which, when implemented, will make DIC the holder of the controlling interest in Cellcom. In the Company's opinion, approval of the merger unconditionally gives rise to an asymmetrical situation in which the Bezeq Group is under severe limitations, whilst the DIC Group, which also holds other communications companies, is not under similar limitations.

2. **FIXED-LINE DOMESTIC COMMUNICATIONS – “BEZEQ” – THE ISRAEL TELECOMMUNICATIONS CORP. LIMITED (“THE COMPANY”)**

Section 2.1 – General information on areas of operation

In the matter of section 2.1.2 of the Period Report – limitations of legislation and delegated legislation, and special obligations – see update to section 2.16.1 below regarding the update of the Company’s tariffs.

Section 2.2 – Products and Services

In the matter of Section 2.2.2 to the Periodic Report – Telephony, on April 21, 2005, the Company received a letter from the Director General of the Ministry of Communications, stating that after examining the various considerations and data submitted to the Ministry, the Minister is considering refusing to give her approval (contrary to the approval in principle given to the Company by the former Minister) to cease the provision of the Bezeqcard service. The Company has objected to the change in the Ministry of Communications' position, having already prepared to terminate the service, based on the approval in principle which had been given to it previously. However, in light of the Ministry of Communications request not to terminate the service until the final decision of the Minister of Communications is obtained, the service has not been terminated. On June 7, 2005, the Minister passed a decision to the effect that the Company would not be given consent to stop providing the “Bezeqcard” service. As at the date of publication of this Report, the Company is acting to reactivate the service, in an orderly and proper manner.

On July 10, 2005, the Ministry of Communications issued a paper on telephone number information services, in an era of multiple communications providers, for public comment. The Ministry gave notice that it intends to examine the need to amend the current arrangement for provision of information services, and that it would consider, *inter alia*, obliging each cellular operator to provide an information service to its subscribers, at no cost, for all cellular subscribers in Israel, as a substitute for the current arrangement. The position of the public has been requested, *inter alia*, with respect to activation of a uniform information call center for all telephone numbers in Israel, or a separate call center for each operator, or for each level of communications (fixed-line, mobile), and activation of the center by communications operators only or by other operators. In a letter of response dated August 9, 2005, the Company submitted its comments on this matter, to the effect that, *inter alia*, these are auxiliary services to the basic service, and in an area in which the services provided are at a high level, and which already embodies the advantages of competition, regulatory intervention is likely to be harmful.

In the matter of Section 2.2.3 to the Periodic Report – Internet access services, as at September 30, 2005, the Company's ADSL subscribers number approximately 771,000 (compared with about 650,000 subscribers at the end of 2004).

Section 2.6 – Competition

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

On April 6, 2005, a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the entities which took part in the privatization process of the Company. The document contains explanations of the main questions raised by the entities which took part in the privatization proceeding, based on the present policy of the Ministry for promoting competition in communications and provisions of the law and existing

licenses, and notes that they should not be cause for expectation or reliance on the part of the participants.

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

On this matter, see also Note 1C(1) to the financial statements of the Company for the period ended September 30, 2005.

b. Interconnect fees

On the matter of the arrangement whereby interconnect fees will not be paid for terminating a call between the networks of the Company and the cable companies ("HOT") described in Section 2.6.1 to the Periodic report – on April 14, 2005, the Company withdrew its petition to the High Court of Justice. On this matter, see also Note 1C(4) to the financial statements of the Company for the period ended September 30, 2005.

c. Competition with “Hot-Telecom”

Competition with HOT is increasing, and is expressed, *inter alia*, in offers by HOT which combine broadband internet, telephony and cable television, aimed mainly at households. In addition, HOT offers telephony services to business customers. According to advertisements in the media, HOT's telephony service has several tens of thousands of customers.

d. VOB Service Policy⁵

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

The Company views this amendment as a possible worsening of its position, and of its subsidiaries, and has given notice to the Ministry of Communications that the amendment that it is considering, as set out above, contravenes the policy principles document. On May 25, 2005, the Company once again contacted the Ministry of Communications, asking for an oral hearing before the Minister of Communications. In its letter, the Company once again clarified, *inter alia*, that it should not be denied the ability to provide VOB services, and that such denial would contradict the license and the law, would be unprecedented anywhere in the world, and would severely harm the Company and its customers;

⁵ Voice Over Broadband

The Company is preparing for a hearing at the Ministry of Communications.

According to its press release, Golden Lines applied to the Ministry of Communications for a special general license for the provision of telephony services on broadband infrastructure. The Company wrote to the Ministry of Communications in this regard, informing it that a special general license should not be given to Golden Lines until the hearing proceeding has ended. As at the date of publication of these Reports, the Ministry of Communications has not replied to the Company.

See also, updates to sections 3.7 and 4.6 below.

e. Marketing trial for payment for VOIP services

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

The Company has applied to the Ministry of Communications with respect to the grant of a marketing trial license for the provision of VOIP services to Cellcom, and has applied for suspension of such at least until the completion of the hearing proceedings and the setting of policy. As at the date of publication of these Reports, the Ministry of Communications has not responded to the Company.

f. Numbering and number portability

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

Notwithstanding the Company's opinion, and to the best of its knowledge, and that of the other licensees, it is not possible to comply with the timetables set out in the draft provided to the licensees including the Company, the Ministry signed a numbering plan for implementation of number portability on August 22, 2005. In this regard, see the Company's immediate report dated August 24, 2005, and Note 1C(5) to the financial statements of the Company for the period ended on September 30, 2005.

As the Company noted in its reports and in detailed letters that it sent to the Ministry of Communications, it will not be possible to meet the timetables set out for implementation of the plan (the signed numbering plan only extended the internal dates – the milestones for planning and installing means for activating number portability – by three months, however the timetable for implementation of number portability flowing from the Law remains as it was). Apart from that, implementation of the plan is likely to require the Company to effect significant investments, which is likely to adversely affect the Company's ability to compete, as well as that of some of the companies in the Group. In the immediate report published by the Company, the Company noted that it was studying the signed plan in comparison with the draft plan and that it intended to continue with its efforts, *inter alia*, to convince the Ministry regarding the need to prescribe more reasonable timetables.

On August 31, 2005, the Company wrote to the Minister of Communications and gave notice, once again, that it was preparing to implement number portability and investment of the necessary resources, however, that the dates for such were not realistic and that the Company would not be able to comply with them. The Company once again asked to be summoned to a hearing in order for it to present the activities that have been undertaken and the reasons for not being able to comply with the timetable to the Ministries of Communications and Finance.

As the Company further noted in an immediate report on March 23, 2005, the implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. In addition, substantial financial investments will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. The activation of number portability also involves costs for joint registration and administration with relevant operators. These are costs that cannot yet be fully estimated. In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the Company's ability to compete.

2. On October 16, 2005, the Company was given a permit to operate a national area code with the prefix 076. Operation of a national area code will enable the Company to allocate national numbers, which is likely to facilitate the provision of national services.

g. Other potential competing infrastructure

Further to the provisions of section 2.6.5(b) to the Periodic Report – certain municipalities are trying to create an alternative to the laying of infrastructure lines by communications licensees, via the infrastructure of such municipalities.

h. The Company's commitments with business customers

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

action relating to foreclosure of the guarantee. "Hot-Telecom" has been joined as a respondent in the petition. Hearing of the petition has been set down for November 17, 2005.

Section 2.9 – Human resources

a. Labor dispute and its subsequent clarification on the matter of the retirement of the remaining transferred employees by 2011

As reported by the Company on April 5, 2005, and April 14, 2004, in immediate reports, on April 5, 2005, the Company received notice of a possible strike at the Company starting on April 21, 2005 ("the Labor Dispute"). After talks between the Government Companies Authority, the Company and the workers' representatives which ended on April 13, 2005, in an exchange of letters between the parties, the Labor Dispute was brought to an end. The main points in the correspondence were these:

- "(1) It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the workers' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which provides that: 'Immediately after signing this Agreement, the parties will start intensive negotiations to arrange the retirement of the remaining transferred employees by 2011 on the one hand, and the demands of the Company's Management for organizational and other changes, on the other hand.'
- (2) The Government Companies Authority clarified that if after sale of the State's holdings in the Company an agreement as referred to above is made, no additional approvals will be required from the Government Companies Authority and the Supervisor of Wages at the Ministry of Finance for extension of the validity of the retirement agreement. The Government Companies Authority also clarified that to the extent that its approval is required for the agreement, the sale of the State's holdings will replace the approval.
- (3) The correspondence will be presented to the participants in the proceeding for the sale of the State's holdings in the Company. "

In the opinion of the Company as at the date of publication of these reports, the above will not change the existing agreements. Furthermore, the aforementioned clarification will not influence the financial statements of the Company. The correspondence was shown to the participants in the proceeding for the sale of the State's holdings in the Company.

- b. In the matter of a one-time bonus to Company employees in the amount of half of the amount of the salary reduction in accordance with the Economic Plan Law and a collective agreement for encouraging economic growth in respect of the period from August 28, 2004, to the date of transfer of the State's holdings to the buyer of the controlling interest in the Company – see update to Section 2.17(b)(2) below and note 1D to the financials statements of the Company for the period ended September 30, 2005.
- c. Section 2.9.5 – the nature of employment agreements at the Company and rationalization programs – following the change in control at the Company, the Company applied to the Ministry of Finance requesting that he ask the Finance Committee of the Knesset to approve an exemption for the Company from the provisions of section 29 of the Budget Foundations Law, following the notice of the (previous) Minister of Finance of his intentions to do so. As the Company has been informed, on November 6, 2005, the Minister of Finance contacted the Chairman of the Finance Committee of the Knesset, asking him to put approval of the Company's exemption from the provisions of section 29(a) of

the Budget Foundations Law on the Committee's agenda, When such exemption is received, the Company shall not be linked to the public sector with respect to the employment of workers. The Company intends to adopt a wage policy suited to its ability and performance.

- d. Section 2.9.6 – employee remuneration schemes – on November 15, 2005 the Company published an outline for 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. On this matter, see also Note 1(g) to the financial statements of the Company for the period ended September 30, 2005.
- e. Section 2.9.7 – officers and senior management employees at the Company – following the change in control of the Company and the termination of office of directors who had acted at the Company prior to the transfer of control (with the exception of external directors), remuneration is no longer paid to directors in accordance with the Government Companies Regulations. As at the date of publication of these Reports, no resolution has yet been passed regarding remuneration to new directors.

Upon completion of the transaction for sale of the State's shares in the Company to Ap.Sb.Ar. (see section 1.3 above), all of the directors acting on behalf of the State resigned from the Board of Directors of the Company, and the appointments of new directors whose election had been approved previously by the general meeting of the shareholders came into force. The external directors who had been acting in the Company prior to completion of the transaction continue to act on the board of directors. There were also changes to management of the Company, which the Company reported in its immediate reports of October 12, 2005, October 27, 2005 and November 1, 2005.

- f. Note that even before completion of the transfer of the State's holdings in the Company to Ap.Sb.Ar., a document of principles was signed between Ap.Sb.Ar. and the workers' organization in preparation for a future agreement between the Company and the workers' organization, which was given to the Company just prior to the date of publication of these Reports, and which contains reference to changes in the organizational structure of the Company relating to retirement and/or firing of employees, reduction of capital whilst maintaining the Company's financial strength, and employee remuneration. As at the date of publication of these Reports, negotiations have not yet begun.

Section 2.10 – Raw Materials and Suppliers, Purchase of Equipment and Suppliers

On the matter of Section 2.10.2 to the Periodic Report – the framework agreement with Supplier D for the purchase and maintenance of transmission equipment has been extended by one year until the end of March 2006.

Section 2.12 – Investments

For sale of the Company's holdings in XPERT Integrated Systems Ltd. see Note 4(c) to the Company's financial statements for the period ended September 30, 2005.

Section 2.13 – Finance

- a. **Section 2.13.4 – Credit received after December 31, 2004**

On April 4, 2005, the Company issued, by way of a private placement to institutional investors, NIS 286,967,000 par value of debentures (Series 5).

The proceeds from the issuance amounted to NIS 315,663,700, where the purchase price for NIS 1 par value is 110 points and reflects a yield of 4.46% (the Company received the proceeds on April 4, 2005). The debentures were listed for trading on the Tel Aviv Stock Exchange and their terms are the same as those of the debentures from the same series which are in circulation (registered debentures, repayable in six equal annual installments in each of the years 2011 to 2016, bearing interest of 5.3% p.a. and not secured by any charge).

In addition, (1) on June 30, 2005, the subsidiary Bezeq Gold (Holdings) Ltd. ("**Bezeq Gold**") sold 100,000,000 par value debentures (series 4) of the Company on the Tel Aviv Stock Exchange. The proceeds, in the sum of NIS 105,160,000, were transferred to the Company in payment of the balance of the loan granted by the Company to Bezeq Gold for the purpose of acquisition of the debentures (series 4). (2) On August 17, 2005, Bezeq Gold sold 100,000,000 par value debentures (series 5) of the Company on the Tel Aviv Stock Exchange. The proceeds, in the sum of NIS 110,950,000, were transferred to the Company in (partial) repayment of the loan granted by the Company to Bezeq Gold for the purpose of acquisition of the debentures (series 5).

b. Section 2.13.6 – Credit rating

1. Moody's rating for eurobonds – On March 7, 2005, the rating forecast was changed from A3 (Stable) to A3 (Negative). The change reflected the uncertainty arising from the expected continuation of the privatization of the Company and the possibility that the new holder of control at the Company (after the privatization is completed) will change the financial strategy of the Company. See the Company's immediate report dated March 8, 2005. Following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co. (see update to Section 1.3 above), Moody's gave notice, on May 10, 2005, that it had placed on review the possibility of reducing the rating of the bonds. Examination of the rating will focus on the uncertainties expected to be derived from purchase of the State's Holdings in the Company by Ap.Sb.Ar. and the fact that changes might take place in the Company's financial policy and strategy. See the Company's immediate report dated May 11, 2005. On October 11, 2005, following completion of the sale of the State's holdings in the Company to Ap.Sb.Ar. (see update to section 1.3 above), Moody's gave notice of a reduction of the Company's credit rating to Baa1, and the rating was kept on review for another possible reduction. See the Company's immediate report dated October 12, 2005.
2. Midroog rating for debentures series (4) and (5) – On March 24, 2005 the rating forecast was changed from Aa1 (Watch List) to Aa1 (Negative). The negative rating horizon was given because of the transfer of control from the State into private hands. See the Company's immediate reports dated March 27, 2005, and March 28, 2005. Following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co., Midroog gave notice, on May 16, 2005, that it was transferring rating of the Company's debt to watch list, for the purpose of examining the possibility of reducing the rating. In Midroog's assessment, sale of the core of control of the Company could have a substantial influence on its business strategy and business and financial profile. See the Company's immediate report dated May 16, 2005.
3. Maalot rating for all series of the Company's debentures – On March 28, 2005, the rating AA was given (no change in the rating). See details of principal considerations for rating in the Company's immediate report dated March 28, 2005. Following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co., Maalot gave notice on May 10, 2005, that the rating of the Company's undertakings was in the process of review (watch list), under which it would look into the effect of

transfer of control of the Company and the business and financial strategies implemented by the purchaser of the core of control of the Company on the Company's rating, and it would publish its conclusions at the end of such review. See the Company's immediate report dated May 11, 2005.

4. Standard & Poors Rating for Eurobonds – following the notice of sale of the State's Holdings in the Company to Ap.Sb.Ar. Co., S&P gave notice on May 10, 2005 that it had placed the Company on Creditwatch, with negative implications to the debentures rated by it at A-. As a result of the expected change in ownership of the Company, S&P expects a basic change in the Company's financial policy and capital structure. See the Company's immediate report dated May 11, 2005. On October 11, 2005, following completion of the sale of the State's holdings in the Company to Ap.Sb.Ar. (see update to section 1.3 above), Standard & Poors gave notice of a reduction of the Company's credit rating to BBB, and that the rating was to remain on creditwatch with negative implications. See the Company's immediate report dated October 12, 2005.

Section 2.14 – Taxation

On taxation, see Notes 2B and 11 to the financial statements of the Company for the period ended September 30, 2005.

Section 2.15 – Environmental protection

- a. On the matter of the Non-Ionized Radiation Bill distributed by the Ministry of the Environment – the revised version of the Bill – the transitional period has been extended from nine months to one year. On June 22, 2005, the aforesaid Bill was published after passing First Reading. A draft is being formulated by a joint interior and environment committee of the Knesset in view of a second and third reading, unifying a number of draft private members' bills in this regard with the government Bill.
- b. On the matter of permits for communications installations under the Planning and Construction law – see the update to Section 2.16 (sub-section g.) below.

Section 2.16 – Limitation and regulation of Company activities

- a. On the matter of number portability, see the update of Section 2.6(f) above.
- b. On the matter of Section 2.16.1 to the Periodic Report concerning regulation of Company tariffs, and Section 2.16.3 to the Periodic Report concerning royalties – on March 29, 2005 the Knesset approved the amendments to the Communications Law described in those sections, as part of the Economic Policy Bill. In addition, on May 31, 2005, an order was published under which the Supervision of Commodities and Services Law is not to apply to telecommunications services for which payment of a fee has been set under section 15(c) of the Communications Law.
- c. Further to Section 2.16.1 to the Periodic Report concerning the regulation of Company tariffs, as the Company reported on May 30, 2005, commencing on June 1, 2005, the Company reduced its regulated tariffs prescribed under section 15(a) of the Communications Law, by an average rate of approximately 2.2%, based on a tariff update formula prescribed in regulations in place at that time. The regulations also contain an amendment of the method of calculation set out below. The aforesaid reduction is based on a change of some 1.2% in the consumer price index and the average rationalization coefficient at a rate of approximately 3.4%. It should be noted that the update includes, *inter alia*, a reduction of approximately 3.2% in call tariffs and an increase of approximately 1.2% in fixed fees. Note that interconnect tariffs were reduced by 3.2% as of September 1, 2005.

On the matter of amendment of the calculation method, as the Company reported in an immediate report dated May 5, 2005, as part of the Ministry of Communications' handling of the annual update of the Company's tariffs, it became apparent to professional staff at the Ministry that it was necessary to amend the method of calculation set out in the regulations in such a way as to enable more precise measurement of the data used for calculating the annual rationalization coefficient.

As the Company reported, according to initial estimates, the immediate affect of the aforesaid amendment would give rise to a reduction in its income in the sum of approximately NIS 30 million per annum in each year of the current tariff arrangement (up to the end of 2007). Apart from the aforementioned, the effect of this amendment, as of the amendment in June 2006, might considerably increase the reduction in the Company's revenues to the extent that the change in the calculation formula will bring about an increase in the tariff reduction coefficient in the coming tariff updates as well, from June 2006 until the end of the arrangement period.

Following reduction of the rate of VAT to 16.5% in September 2005, the Company's tariffs were updated accordingly. Later on, some of the Company's tariffs were amended (and published in the tariff regulations) in force as of November 1, 2005, in order to retain "rounded off" tariffs for these services, including the new rate of VAT.

- d. Regarding Section 2.16.2 – the main points of the amended license/tariffs – following the Company's notice of its intention to demand the participation in payment of a commission by subscribers who pay through the Postal Bank, the Ministry announced that it is considering amendment of the Company's license so that it will determine that the Company must enable a range of means of payment of its bills, including through the Postal Bank. The Ministry also stated that its position is that the Company may not collect such a commission. The Company responded that the proposed amendment of the license and the position of the Ministry of the matter are beyond its authority and unreasonable. Attempts to speak with the Ministry of Communications in this matter have been fruitless, and as at the date of publication of these reports, the Company does not require that subscribers paying via the Postal Bank participate in payment of the commission to that Bank.
- e. Further to Section 2.16.2 to the Periodic Report concerning the general license of the Company:
 - (1) On July 14, 2005, the Company's general license and the licenses of other operators were amended. The amendment to the license prescribed that the Company must act in accordance with the Israeli Standard regarding reliability of bills and due disclosure in telephone accounts. In addition, provisions that are different from those in the aforesaid standard were prescribed regarding rounding off of sums in bills. Under the amendment, the provisions of the standard regarding due disclosure in telephone bills will come into force by October 14, 2005, whilst provisions relating to reliability of billing will come into force by January 14, 2006. The Company's license was amended in this manner, despite the fact that the Company expressed its opinion to the Ministry that there is no room or justification for the standard in its proposed format, and certainly not for changing it, by adopting it in the license, into a binding standard, bypassing the statutory mechanism set out in the Standards Law. Likewise, the Company clarified that implementation of the standard involves investment of considerable resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be done at the same time as implementation of the number portability program, and that it needs a longer period of time to implement the standard. The

Company is prepared to implement the standard in accordance with the amendment of its license, however, at the same time, it contacted the Ministry of Communications and gave notice to it that it would not be able to meet the dates set out for implementation of the standard under the amendment of the license, and asked that the matter be presented to the Ministry in order that the Company's request for a longer preparation period may be re-examined. On October 16, 2005, the Director General of the Ministry of Communications gave notice to the aforesaid licensees that due to the consumer importance of the issue, there will be no delays in implementing due disclosure, but the Company's position is as above.

- (2) On June 8, 2005, the Ministry of Communications provided a draft appendix to the general licenses to the cellular licensees, HOT and the Company, for remarks, regarding replacement of the "erotic services" appendix with "adult services". Under the draft appendix, a variety of services that are not appropriate for minors, due to their nature and substance, will be regulated by way of use of access code 1919, instead of what the Ministry sees as the restricted arrangement of "erotic services". The proposed amendment extends the content that may be offered via the aforesaid prefix to all "adult services" such as introductions, chats, matchmaking, etc., and prescribes clear rules for "reliable identification" of an adult prior to removal of the block. The Company, without going into the main body of the matter, asked that the requirement to play a voice message to all subscribers blocked from the service not apply to a licensee which does not itself produce the service, since the technology by which the Company currently provides access to the service, and which was adopted based on the previous amendment to the license, does not enable this.

f. On the matter of section 2.16.3 to the Periodic Report concerning royalties –

- (1) On May 2, 2005, the Company received a copy of a letter dated April 20, 2005 sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties. According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the proceeding for sale of the State's Holdings in the Company and as part of the preparations for the implementation of the number portability service throughout the entire telecommunications sector, the Telecommunications (Royalties) Regulations are to be amended by the Ministries and brought for the approval of the Minister of Communications, the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until reaching a rate of 1% in 2010.
- (2) Concerning the dispute between the Company and the Ministry of Communications regarding the payment of royalties for revenue from interconnections from cellular subscribers to subscribers of the Company during the period between April 1999 and the end of 2000, on July 25, 2005, the Company received a letter from the Director General of the Ministry of Communications demanding that the Company pay the above royalty debt in dispute in the sum of approximately NIS 17 million. The Company replied to the Ministry of Communications that it was taking the legal position and that Ministry

had not given reasons for its decision and had not referred to claims and data recently presented by the Company to professional staff at the Ministry. The Company also sought to hold urgent talks with the Director General of the Ministry of Communications in this matter, and to postpone the demand for payment until such talks could take place. On this matter, see also Note 6A(14) to the financial statements of the Company for the period ended September 30, 2005.

- g. Concerning Section 2.16.10(b) to the Periodic Report regarding permits for communications installations under the Planning and Building Law, including permits of the Commissioner for Radiation:
- (1) Due to intensive activities being carried out 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. As at the date of publication of these reports, the Company is dealing with the issue of permits from the relevant licensing authorities, with respect to 26 other small broadcast installations only.
 - (2) For the amendment to NOP 36A – see update to Section 3.18(c) below.

Section 2.17 – Material agreements

- a. Regarding Section 2.17.2 (deed of trust for debentures (series 5) dated May 24, 2004, and an addendum to that deed dated December 6, 2004) – on March 30, 2005, an additional addendum to the deed of trust was signed between the Company and the Mizrahi Bank Nominee Company Ltd. in respect of an issue of NIS 286,967,000 par value of debentures from the same series. See the update to Section 2.13 above and the Company's immediate report dated March 30, 2005.
- b. Regarding Section 2.17.7 to the Periodic Report –
- (1) On April 17, 2005, a special collective agreement was signed between the Company, the Workers Committee and the Histadrut, concerning an arrangement with an alternative entity to the Makefet Fund for everything relating to early retirement arrangements for Company employees.

In addition, on June 28, 2005, an agreement was entered into between Harel Insurance Company Ltd. ("Harel") and the Company. 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).

As a result of the contract with Harel, the Company reduced its provision for early retirement, after performing adjustments that also stem from an updated estimate of the total retirement liabilities of NIS 90 million in its financial statements for the period ended June 30, 2005.

On this matter, see also Note 5A to the financial statements of the Company for the period ended September 30, 2005.

- (2) On May 3, 2005, a special collective agreement was executed between the Company, the employee representation and the General Trade Union regarding payment of a one-time grant in the sum of part of the amount of reduction of salaries under the Israeli Economy (Recovery Program) Law and under the collective agreement for encouragement of economic growth immediately after completion of sale of the State's holdings in the Company. See also update to Section 2.9 above (sub-section (b)).

Section 2.18 – Legal proceedings

For updates on the subject of legal proceedings, see Note 6 to the financial statements of the Company for the period ended September 30, 2005, and section 1.1 above.

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

- a. Regarding the proceeding for privatization of the Company and completion of transfer of the State's holdings in the Company to Ap.Sb.Ar., see the update to Section 1.3 above.
- b. **The “Industrial Espionage” Incident**

On May 29, 2005, the media published that the Israel Police Force was conducting an enquiry regarding “industrial espionage” via computer systems in which, according to such publications, the subsidiaries of the Company – Pelephone, Bezeq International and DBS – were also involved. As a result, senior employees of those subsidiaries were called in for inquiry and/or to give evidence.

Pelephone notified, in response to the aforesaid publications, that neither it nor its employees had any connection to the obtaining of information by unlawful means, that it and its employees were surprised by the publications and that they would cooperate with the Police in order to clarify the facts in the incident.

In November 2005, a claim was filed with the District Court at Tel Aviv against Pelephone, and against Civil Intelligence "(Modi'in Ezrahi)", for grant of an order to report, together with an application for the splitting of remedies. The cause of action revolved around claims whereby, Pelephone allegedly ordered commercial information regarding the plaintiff's business, and that such information was supplied by Civil Intelligence, in violation of a number of statutory provisions, and as part of the Trojan Horse incident. At this stage, Pelephone is unable to assess the chances or consequences of this claim. See also Note 6A(26)(c) to the financial statements of the Company for the period ended September 30, 2005.

Bezeq International gave notice, in response to the summons to investigation of its employees, that it would give the Police all assistance required, and that it would not have assisted or touched material obtained in unlawful ways. Concerning Bezeq International in this affair, see also Section 4.1 below.

DBS gave notice in response to the aforesaid publications that if offenses were committed against the law, they were committed in express contravention of its instructions and that it had not sufficed with entry into an oral contract with the investigation company, but rather, had had the investigation company sign an unequivocal undertaking to act only in accordance with the law, and the investigation company had undertaken that it and all those taking part in the agreement with it would act in accordance

with the law. It should be noted that the cable companies filed a claim against DBS in which they requested an order declaring that the cable companies were the owners of all of the secret materials obtained, allegedly, by DBS unlawfully, and orders instructing DBS to avoid any use of such materials. In a hearing which took place on July 7, 2005, an order was given with the consent of the Parties, to the effect that DBS would not make use of the documents and information relating to the cable companies allegedly transferred to it from the investigation companies. Regarding DBS in this incident, see also Note 6A(26)(a) to the financial statements of the Company for the period ended September 30, 2005.

It should be noted that a number of senior employees of the Company were summoned, immediately upon publication of the incident, to give evidence to the Police regarding confidential documents of the Company which were found in the possession of competitors, and to evaluate the level of damage expected to be incurred by the Company as a result of such. The Company examined this issue and took immediate action with the aim of reducing the risk of information being taken out of the Company, as far as possible.

On the implications of this incident on the privatization of the Company, see the update to Section 1.3 above.

3. CELLULAR – PELEPHONE COMMUNICATIONS LTD. (“PELEPHONE”)

Section 3.1 – General information on areas of operation

On the matter of the “industrial espionage” incident, see Section 2.20(b) above.

On Section 3.1.5.2 – the PTT (Push To Talk) service was launched at the beginning of 2005, at a reduced level, and as of July 2005, the service can be marketed in full without limitation. MIRS applied to the Ministry of Communications and petitioned the High Court of Justice requesting that the Ministry of Communications extend the period in which the marking limitation applies to the other cellular companies. During the course of the hearing held in the High Court of Justice, the State gave notice that it intended to reject MIRS’s application and that a notice in writing would be sent out to the parties involved.

Section 3.2 – Products and Services

Regarding section 3.2.2 – during 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets will provide an additional solution to roaming services in other countries where the network is not CDMA.

Section 3.7 – Competition

On the matter of number portability, see the update of Section 2.6(f) above. Implementation of the number portability plan will impose costs on Pelephone, the complexity, scope and implications of which cannot yet be assessed. As at the date of these Reports, Pelephone, and to the best of Pelephone’s knowledge, the other cellular companies as well, are not in compliance with the timetables, and notices in this regard have been given to the Ministry of Communications from all of the companies. However, the Ministry of Communications has not given notice of any change in the timetables.

Regarding section 3.7.2, the Ministry of Communications some time ago gave notice, as part of a process of final formulation of its policy regarding the field of licensing of supply of telephony services by way of a broad band access service (VOB), of its intention not to permit the companies in the Bezeq Group (including Pelephone) to take part in this field so long as the Company’s portion of the fixed-line domestic telephony field in the segment of certain customers does not fall below a given threshold, or earlier taking into account the situation of competition in the field, after an

examination to take place at examination stations on the timeline and on prescribed dates. 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 with the Company. Pelephone is waiting to present its arguments in a hearing before the Ministry of Communications. Pelephone has submitted an application to the Ministry of Communications for the effecting of a marketing trial of VOIP technology, and in response, the Ministry noted that it could grant Pelephone a license for such trial subject to conditions, that main ones of which would be a provision in the license that if at the end of the hearing the policy document is amended, such that Pelephone is prohibited from providing VOB services, the trial license shall expire. On this matter see also section 2.6(d) and (e) above.

Section 3.11 – Human resources

For changes to the Board of Directors following the change in control of the Company, see section 1.3 above. Following the appointment of the CEO of Pelephone as CEO of the Company, changes were also made to management of Pelephone.

The Terminal Equipment Services Division has been brought in under the Operations Division.

Section 3.14 – Investment in Subsidiaries and Partnerships

At the end of the third quarter, it was resolved to wind up the B-One partnership. As of the fourth quarter, Pelephone has taken over management of the undertakings given by the partnership. (see Note 4(d) to the Company's financial statements for the period ended September 30, 2005).

Section 3.15 – Finance

On June 29, 2005, Pelephone issued NIS 333 million par value debentures by way of private placement, in return for their par value (see Note 1E(4) of the Company's financial statements for the period ended September 30, 2005).

Section 3.18 – Restriction and control of Pelephone's actions

- a. Regarding the matter of number portability – see the update of Section 3.7 above.
- b. Regarding section 3.18.2 to the Periodic Report (regulated tariffs) – in partial compensation for reduction of the tariffs referred to in that section, Pelephone raised the outgoing call tariff from the Pelephone network and the SMS tariff for outgoing messages from the Pelephone network during the course of the year.

In recent months, a hearing was held in writing and orally regarding the interconnect tariffs for all cellular carriers, and as at the date of publications of these reports, Pelephone is waiting for a decision to be made by the Ministries of Finance and Communications.

- c. Regarding Section 3.18.3.3 – set up of communications installations – NOP 36 – on July 24, 2005, the Government of Israel decided to temporarily postpone approval of the resolution of the National Planning and Building Council regarding amendment of National Outline Plan 36A dealing with the set-up of small and minor broadcast installations. The amendment revolved around expansion of the discretion of local committees, provision of objection rights to the public and requiring companies to deposit undertakings to indemnify the planning committees for claims of devaluation of land. The cellular companies' portion of this indemnification was budgeted at 80% of the value of the devaluation and the balance is supposed to be borne by the local committees. The aforesaid postponement is intended to enable the committee of CEOs that was set up, to submit its conclusions within three months. Approval of the amendment as placed before the Government will have severe implications on

the ability of the cellular companies (including Pelephone) to develop their networks, and the existence of an indemnification obligation will impose an inestimably heavy economic burden on them. The committee is supposed to be finishing its work and submitting its recommendations for government approval in the next few days. To the best of Pelephone's knowledge, the committee's recommendations are, in principle: Creating a distinction between small and large sites, the licensing process for small sites being either via an exemption from license track or a fast licensing track, whilst for large sites, a complex licensing process will be required, including giving the public the opportunity to express its objections. Likewise, there will be a distinction between small and large sites with respect to indemnification. There shall be no indemnification requirement for sites that are exempt from licensing, whilst for medium-sized sites there will be an indemnification requirement, the division of the onus still being in discussion. Likewise, implementation of the committee's recommendations requires an amendment to the Planning and Building Law, and therefore, it is not possible to estimate the timing of the end of this process. The committee intends to recommend an arrangement to apply in the intervening period. On the matter of the petition filed in the High Court of Justice in this matter against the Government, Pelephone and others, see Note 6A(19) to the financial statements of the Company for the period ended September 30, 2005.

Section 3.19 – Legal proceedings

For updates on the subject of legal proceedings, see Notes 6A(7), 6A(17) through 6A(21) and 6A(26)(c) to the financial statements of the Company for the period ended September 30, 2005.

Section 3.21 – Expected developments in the coming year.

For the tender of the "Yoter" Soldiers' Welfare Association and the IDF tender in section 3.21.3 of the Periodic Report, competing cellular companies won those tenders.

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

Section 4.1 – General

On the matter of the "industrial espionage" affair – On May 31 2005, three employees of Bezeq International were called in for questioning as part of the police investigation into industrial espionage by computerized means (a Trojan horse program). After being questioned, the employees were released with restrictions. Up to the date of publication of the interim financial statements, no proceedings have been instituted against Bezeq International and/or its employees relating to the above investigation. On this matter, see also Note 2.20(b) above and Note 6A(26)(b) to the financial statements of the Company for the period ended September 30, 2005.

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

Section 4.2 – Products and Services

During the third quarter of 2005, Bezeq International set up an Integration and New Business Department, whose operations shall focus on the fields of data, hosting (of servers and websites), and total integration solutions for businesses.

Section 4.4 – New products

New products launched in 2005:

- a. Hosted Exchange services – A managed e-mail service. The service is based on a model of providing remote managed solutions on the broadband infrastructure, which reduces a business's costs compared with the alternative of purchasing a server and licenses.
- b. Mobile Max services – This service enables convenient use of dialing from abroad to Israel from supporting cellular handsets, using a Bezeq International phone card.
- c. Call Back service – A phone card service from abroad to Israel which enables the direction of a call to be reversed (Israel – abroad), thereby reducing costs.

Section 4.6 – Competition

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

Implementation of the numbering plan and number portability (as detailed in the update to Section 2.6 above, sub-section F) is liable to compel Bezeq International to make additional investments in infrastructure and equipment. Bezeq International cannot, at this stage, estimate the total extent of such investments.

Section 4.10 – Human resources

For changes to the Board of Directors, see section 1.3 above.

Section 4.17 – Limitation and regulation of Bezeq International activities

Regarding section 4.17.1.3 to the Periodic Report regarding royalties – see update to sections 2.16 and 4.1 above.

Section 4.19 – Legal proceedings

- a. With regard to the claim of an equipment supplier which was filed on November 24, 1998, in the Tel Aviv District Court against Bezeq International and the Company, as described in Section 4.19.1 to the Periodic Report, the Court recommended to the parties, in a pre-trial hearing on March 2, 2005, to make a further attempt at mediation and to notify it of their decision. The file is in the evidence stage at present.
- b. With regard to the claim filed on April 4, 2004, in the District Court at Jerusalem by a competing international communications operator, as described in section 4.19.2 to the Periodic Report, a pre-trial hearing of the action was held on April 10, 2005, in which the Court recommended to the parties to apply for a mediation proceeding. The plaintiff and the State of Israel

consented to the mediation proceeding. On April 17, 2005, Bezeq International and the Company gave notice that they do not consent to a mediation proceeding. The matter is in preliminary proceedings.

- c. With regard to the claim filed on January 2, 2005, by persons alleging to be the inventors and patentees of a prepaid telephone system, as described in Section 4.19.3 to the Periodic Report, after Alcatel Telecom Israel Ltd. ("Alcatel") contacted Bezeq International on April 20, 2005, Alcatel took over management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel replaced Tadiran for the matter of this agreement). On July 17, 2005, statements of defense on behalf of Bezeq International and a third party notice, against supply of an additional system operated by Bezeq International and used for the supply of the services under the Claim. On September 30, 2005, a statement of defense was filed by another system supplier. The statement of defense filed by such supplier claimed, *inter alia*, that the systems supplied to the Company do not infringe the patent under the claim, and that the respondent supplier does not owe the Company anything based on the provisions of the Law and the agreements between the Parties.
- d. On February 27, 2005, Bezeq International's general license for the provision of international telecommunications services (the "license") was amended by the addition of an appendix which dealt with access to erotic services (services offered via a telecommunications installation containing messages with sexual content) via the international dialing services supplied by Bezeq International. Under the provisions of this amendment (clause 58A of the license, Bezeq International must block outgoing call access to any telephone number dialed without a dialing prefix prescribed by the Ministry of Communications for an erotic service (1919 prefix), to the extent that the Ministry of Communications has given it notice, or it has become aware in some other way, that an erotic service is being offered via such number. In reliance upon the findings of the Supervision Report, which the Director General of the Ministry of Communications views as arousing a real suspicion that Bezeq International is in breach of the abovementioned conditions of its license, the Director General of the Ministry of Communications gave notice to Bezeq International that he was considering imposing a financial sanction upon Bezeq International, in the sum of NIS 2,257,500, based on the right afforded to him under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "Law"), in the event of breach of a condition of the license. Pursuant to the provisions of the Law, Bezeq International was given an opportunity of making claims in writing, in response to the charges of the Ministry, by September 6, 2005. In its Supervision Report, the Ministry of Communications raises suspicions that Bezeq International entered into an agreement with a foreign carrier to the effect that it would transfer traffic to such carrier to fictitious destinations outside of Israel, intended, in effect, for the providers of erotic services operating in Israel, and that such operator would redirect such traffic to Israel via Bezeq International's international telecommunications system; such that the profits from these calls would be divided up between Bezeq International and the aforesaid foreign carrier. More seriously, at the center of its conclusions in the Supervision Report, the Ministry of Communications alleges that it can be held, in reliance upon the findings of its investigations, that: "Bezeq International was an active party to the provision of erotic services via its international telecommunications system, and that in respect of the period from 2004 until January 2005, the Company effected short termination redirection of calls, without such calls ever leaving the boundaries of the country."

On October 17, 2005, Bezeq International filed its response to the Director General's above notice to the Ministry of Communications, in which it claimed, *inter alia*, that: Bezeq International has never provided any form of erotic

services, does not and did not have any commercial relations with suppliers of erotic content in Israel or overseas; Bezeq International has always been in strict compliance with the provisions of its license and the instructions of the Ministry of Communications and has acted effectively to block overseas destinations used for erotic services, to the extent that the Ministry of Communications has instructed it to do so; in any event, the Ministry of Communications has no real evidence that Bezeq International has breached the conditions of its license, and the charges against Bezeq International are based merely on groundless theories and baseless presumptions.

As at the date of this Report, the response of the Ministry of Communications to Bezeq International's response has not yet been received.

For further updates on the subject of legal proceedings, see Notes 6A(6), 6A(16) and 6A(26)(b) to the financial statements of the Company for the period ended September 30, 2005.

Section 4.21 – Risk factors

- a. Section 4.21(e) – Anchor countries – concerning a commitment made by Bezeq International in its official price list to the lowest prices in four countries (USA, Russia, France and Argentina) until the end of 2005, and consequently the possible adverse effect on the revenues of Bezeq International if the price lists of its competitors are revised to below Bezeq International's prices – during the first quarter of 2005 the tariff to these four countries was revised from 44 agorot per minute to 29 agorot per minute.
- b. Additional risk factor – International communication cables – The laying of a gas pipe along the shores of Israel by the Israel Electric Corporation is liable to damage the underwater communications cable system which is the main artery of Israel's international communications. The matter is being handled by the Ministries of Communications and Infrastructures. Med Nautilus, the company responsible for most of Bezeq International's underwater communications cable system, announced that its network is properly backed up and secured, including the marine connection relating to the gas pipe. In the estimation of Bezeq International, In view of this notice, the risk level of such damage appears to be low.

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

Section 5.1 – General information on areas of operation

The number of DBS subscribers as at September 30, 2005 amounted to approximately 512,000.

For the “industrial espionage” incident see Section 2.20(b) above and Note 6A(25)(a) to the Company's financial statements for the period ended September 30, 2005.

Regarding section 5.1.2 to the Periodic Report (limitations, legislation and special restrictions) – on October 30, 2005, the Government decided to unify the operations of the Cable and Satellite Broadcast Council, the Second Television and Radio Authority Council, the Second Television and Radio Authority and the Public Broadcasts Regulation Administration into a single unified Commercial Broadcasts Authority, which shall be responsible for regulating all of the commercial television and radio broadcasts in Israel. The government has instructed the Ministry of Communications to prepare and distribute a Government Bill to regulate this change.

Regarding Section 5.1.5 to the Periodic Report (Substitutes for Products in the Area of Operations and Changes Applying to them) –

- a. an inter-ministerial committee was recently set up comprising of representatives of the Ministries of Finance and Communications, with the purpose of examining turning the terrestrial offices of the Broadcasting Authority and the Second Authority into digital offices in such a way as to enable national digital broadcast of Broadcast Authority and Second Authority transmissions. To the best of DBS's knowledge, no resolutions have yet been adopted on the matter.
- b. On August 9, 2005, the government decided to require the Minister of Communications and the Minister of Finance to do all of the acts required such that no later than January 1, 2007, 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. As part of this discussion, various governmental authorities have been instructed to promote and implement the decision, and in this context, to publish a tender to select an entity to plan, set up and operate the terrestrial digital broadcast system, and the digital satellite distribution system. If the government decision set out in this sub-section is put into action, the broadcasts of these channels shall constitute a partial substitute for DBS's broadcasts. DBS has submitted its objection to the proposal to the Minister of Finance and the Minister of Communications, under which it has even requested to hold a hearing preceding which it is to be provided with information under the Freedom of Information Law, 5758-1998.
- c. On August 9, 2005, the Government resolved to require the Minister of Communications and the Minister of Finance to take all action 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 the Company'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, legislative amendments relating to implementation of this decision have been included in the memorandum for the proposed Budget Law for 2006, which is to be submitted to the Knesset in the forthcoming weeks.

For Section 5.1.6 (structure of competition in the field of operations and the changes applying to it), the cable companies have recently started the sale and marketing of a basket of services, including multi-channel television, internet and fixed-line telephony.

Section 5.6 – Competition

For section 5.6.1 of the Period Report concerning competitors in the broadcasts market – DBS's portion of the multi-channel television market as at September 30, 2005, is estimated, to the best of its knowledge, at approximately 36% of total subscribers.

Further to Section 5.6.4 concerning positive and negative factors in competition – With respect to the advanced services including immediate video upon the individual demand of subscribers via broadband fixed line infrastructure – following applications by DBS to the Ministry of Communications to approve the grant of a license without the need for amendment of legislation, on October 11, 2005, DBS received a reply from the General Counsel of the Ministry of Communications to the effect that DBS's application to provide such services was still being examined by the professional staff

at the Ministry of Communications, together with the Public Broadcast Regulation Administration and the Ministry of Finance, and it was noted that an application would be made to the relevant persons to receive their positions. It was also noted in this reply that the receipt of a commercial license for the provision of the above services would require an amendment to legislation and that DBS's application for a commercial license for the provision of such services and a license for the performance of a marketing test are not possible for that reason. On October 27, 2005, the Senior VP Economics and Budget at the Ministry of Communications wrote to DBS (and to the best of its knowledge, to several other persons in the communications industry, including Bezeq, the cable companies and internet access licensees), requesting their positions on the matter by December 25, 2005. In its letter to the Company, the Ministry of Communications asked to examine specific issues relating to network capacity, the possibilities of use of it and pricing of the service.

Section 5.8 – Intangible assets

On the matter of section 5.8.1 to the Periodic Report – licenses – DBS's license to effect uplinks has been extended until January 19, 2014, or until the end of the term of DBS's broadcast license, whichever is the earlier.

Further to Section 5.8.1.2 to the Periodic Report – in February 2005, DBS contacted the Civil Administration with an application to extend the term of its license for satellite broadcasts in Judea, Samaria and the Gaza Strip until 2014. In June 2005, a representative of the Civil Administration replied that in light of the special conditions in Judea, Samaria and the Gaza Strip, there is no room, at this stage, to extend the term of the license, and therefore, the term of the above license remains unchanged (until January 2009).

Further to Section 5.8.1.3 to the Periodic Report – DBS is acting in order to extend the term of the license to effect uplinks, which expires on October 31, 2005 (and not until April 2006 as set out in the Periodic Report), until the latest date possible.

Section 5.9 – Human resources

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

Section 5.12 – Finance

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

In June 2005, an institutional entity which provided DBS with a long-term loan in April 2005 as set out above, exercised the option given to it under the loan agreement, and provided DBS with an additional loan in the sum of NIS 20 million, on the conditions of the original loan agreement. In September and October 2005, two institutional entities which had entered into loan agreements with DBS in March and April 2005 for long term loans exercised the option afforded to them under the loan agreements and provided DBS with an additional loan in the sum of NIS 30 million, on the conditions of the original loan agreements.

On this matter, see also Note 4(a) above and Note 6B to the financial statements of the Company for the period ended September 30, 2005.

Further to section 5.12.3 to the Periodic Report (credit sums received in 2004), since the beginning of 2005, DBS has received loans from shareholders and others in the sum of NIS 167 million and the banks have increased their credit by approximately NIS 18 million.

Further to Section 5.12.4 (credit of corporation) – DBS's credit allowance is approximately NIS 1,379 million. As at September 30, 2005, DBS has utilized NIS 1,368 million of its credit allowance.

Section 5.14 – Restrictions and supervision of the corporation

Further to Section 5.14.1 to the Periodic Report, specific legal restrictions on operations – according to a decision of the Cable and Satellite Broadcast Council (the “**Council**”), in 2002 DBS was in compliance with its obligation to invest in local productions, except for approximately NIS 3,900,000 and under-investment of approximately NIS 7,800,000 in original quality productions, and in 2003, DBS had met the obligation to invest in local productions except for the sum of approximately NIS 370,000 and under-investment of approximately NIS 5,200,000 in original quality productions, however the Council allowed DBS to make up these shortfalls during 2004 and 2005 (with original quality productions). DBS notified the Council that it had met its local production obligations for 2004 (including the proportional part of completing past obligations), and the matter is currently being examined by the Council. For 2006 onwards, no decision has been made as yet with regard to the percentage of DBS's revenues that will be invested in local productions (according to the Communications Law, that percentage is between 8% and 12% of the revenues), but the Communications Law states that increasing the percentage of the investment in local productions required of DBS necessitates a hearing for DBS by the Council, and DBS is unaware of any plans for such a hearing. According to a decision of the Council dated September 2005, the rate of investment of DBS's revenues in local productions during the years 2006 and 2007 will stand at 8% of such revenues.

Further to Section 5.14.2 – subordination of operations to the broadcasting license – according to a decision of the Supreme Court on March 22, 2005, in HCJ 7200/02 filed by DBS against the Council & Ors., apart from the Minister of Communications' authority to amend the broadcasting license of DBS (in consultation with the Council), the Council alone may also modify the terms of the broadcasting license, provided that before doing so, it gives the licensee the opportunity of a fair hearing.

Further to Section 5.14.3 to the Periodical Report – on June 30, 2005, the Satellite and Cable Broadcasting Council (hereinafter: the “**Council**”) passed a resolution regarding an “invitation to present positions regarding rules of ownership of channels produced in Israel”, as part of which, the Council invited the public to present it with its positions in this regard, including on the question of whether DBS should be under the channel production restrictions which apply at present only to cable companies, and in the event that it should be, which amendments and adjustments ought to be made to them in comparison with the rules currently applying to cable companies. In July 2005, DBS submitted its remarks in this regard to the Council, and in doing so, expressed the position that there was no room for applying limitations in the matter beyond those already set out in the Law at present.

Regarding the dispute use by DBS of cable infrastructure at subscribers' homes – in 2001, the Ministry of Communications issued an administrative order regulating the method of transfer of a subscriber from the services of the cable companies to DBS and vice-versa, and the use of infrastructure in the subscriber's home. The administrative instructions also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider. Since enactment of the Administrative Instructions, DBS and the cable companies have brought mutual complaints regarding breach of the Administrative Instructions by the other party, and considerable correspondence has taken place between DBS and the Ministry of Communications in this regard. On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable companies that in light of their many breaches of the Administrative Instructions, 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 Instructions should remain in place, 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 companies title to the wiring installed by them in private homes. DBS also claimed that the sum set out in the Law as the consideration to be paid for purchase of the wiring (NIS 120) has no basis and that should the provision remain in force, it should be reduced considerably. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and has many faults, and will prevent the proper transfer of subscribers under it, and will harm competition. On this matter, see also Note 6A(24) to the financial statements of the Company for the period ended September 30, 2005.

Section 5.15 – Material agreements

Further to Section 5.15.2 to the Periodic Report – pursuant to the Second Space Agreement (as defined in section 5.15.2 to the Periodic Report), in May 2005, DBS began to lease two additional space segments on the Amos 2 satellite, so that as at the date of this report, DBS leases a total of 6 space segments on the Amos 2 satellite. As at the date of this Report, DBS leases 7 space segments on the Amos 1 satellite, due to a technical limitation that is preventing the continued lease of the eighth space segment, and until solution of that limitation, rental is not being paid for the aforesaid eighth segment.

Further to Section 5.15.5 to the Periodic Report – finance agreement with the banks – See the update of Section 5.12 above.

Section 5.17 – Legal proceedings

- (a) Further to Section 5.17.3 of the Periodic Report in the matter of the petition filed by DBS to the High Court of Justice against the powers of the Minister of Communications to intervene regarding the injection of funds into DBS, and the matter of the appeal filed by DBS regarding the conditions of the merger with the Company, see the update to section 1.1 above.
- (b) In May 2005, arbitration proceedings commenced between DBS and Play TV Ltd., the producer of the "Playboy" and "Adult" channels (hereinafter: "Play TV" and the "Channels") regarding an argument by DBS regarding its right to rescind the agreement, and regarding other claims by Play TV as to performance of the Agreement. Following an application for interim relief submitted by Play TV, the arbitrator decided, on June 9, 2005, that DBS would not be able to offer an erotic channel produced by another supplier at a cheaper rate than the "Adult" Channel, and that DBS would not display that channel as a preferable channel the Play TV Channels. On June 22, 2005, the

parties submitted their pleadings to the arbitrator. In the claim filed by DBS, DBS petitioned for declaratory relief under which the agreement between the parties had been legally voided due to the broadcast of a film on the Channel, on three separate occasions, the content of which contravened the provisions of the Communications Law, and the Council's resolutions (hereinafter: the "Film"). In a suit filed by Play TV, it claims the sum of NIS 6,159,800, based on Play TV's claims regarding campaigns run by DBS, under which the Channels and films produced by Play TV were offered at a reduced price, without this being coordinated with it, and regarding various errors in DBS reports, on the basis of which, the consideration paid to Play TV is prescribed. Play TV also applied for declaratory relief under which the notice of rescission of the agreement was given unlawfully, that the monetary sanction imposed by the Council for broadcast of the Film be paid by the parties in equal shares, award of a mandamus order regarding broadcast of an "Adult" channel in a pay-per-night (PPN) viewing format, and comparison of its price as against the price of another erotic channel broadcast as part of DBS's broadcasts, and other auxiliary relief. The parties' responses to the mutual claims have yet to be filed. DBS gave notice to Play TV that notwithstanding its claims, *ex gratia* until the arbitrator's ruling on the matter, DBS would suspend the operative results of rescission of the agreement between the parties and would continue to act in accordance with the provisions of it. The file is in the evidence stage at present. At this stage, DBS's legal counsel are unable to assess the outcome of this dispute..

- (c) For further updates on legal proceedings, see Notes 6A(22), 6A(23), 6A(24) and 6A(26)(a) to the financial statements of the Company for the period ended September 30, 2005, and section 1.1 above.

November 16, 2005

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Moshe Arkin, Chairman of the Board of Directors

Yacov Gelbard, CEO

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

Directors Report on the State of the Company's Affairs for the period ended September 30, 2005

We respectfully present the Directors' Report on the state of the affairs of "Bezeq" – The Israel Telecommunication Corp. Limited (hereinafter: the "Company") and the consolidated Group companies (the Company and the consolidated companies hereinafter collectively referred to as the "Group"), for the nine-month period ending September 30, 2005 (hereinafter: "the Directors' Report").

The Directors' Report contains a review of its subject matter, in condensed form, and is prepared on the assumption that the reader can also refer to the Directors' Report for the year ended December 31, 2004.

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

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

Below is information detailing the financial statements which were fully consolidated during the period of account and which were not included in the entire corresponding period in the prior year:

1. Pelephone Communications Ltd. – full consolidation since August 26, 2004 (until that date, 50% proportional consolidation).
2. D.B.S. Satellite Services (1998) Ltd. – full consolidation since June 21, 2004.

1. Financial Position

- A. The Group's assets as at September 30, 2005, amounted to approximately NIS 20.65 billion, compared with NIS 19.99 billion as at September 30, 2004. Of these, approximately NIS 10.12 billion (approximately 49%) are fixed assets compared with approximately NIS 10.72 billion (approximately 53.6%) on September 30, 2004.

In the fixed-line domestic communications segment, there was a decrease in the net book value of fixed assets resulting from the difference between depreciation expenses and the investment made during the period of account. Conversely, there was an increase in cash balances and short-term investments compared with the prior year.

In the cellular segment, there was an increase in cash and cash equivalents, short-term investments and trade receivables, which contributed to the increase in total assets. Conversely, there was a reduction in the deferred tax balances due to utilization of prior years' losses for tax purposes.

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

In the multi-channel television segment, total assets increased compared with the prior year, mainly due to a rise in broadcasting rights and in the customer credit balance. Conversely, there was a decrease in net investments in fixed assets

- B. The Group's shareholders' equity as at September 30, 2005, amounted to approximately NIS 8.01 billion, comprising approximately 38.8% of the total balance sheet, compared with approximately NIS 7.36 billion on September 30, 2004, which comprised approximately 36.8%

of the total balance sheet. The increase in shareholders' equity derived from the Group's net earnings accumulated since the end of the corresponding period.

- C. Total Group debt to financial institutions and debenture holders as at September 30, 2005, amounted to approximately NIS 9.08 billion, compared with approximately NIS 8.26 billion on September 30, 2004. The increase derives mainly from an offering of debentures which was offset by repayment of long-term loans in the cellular and fixed-line domestic communications segments.
- D. Group balances in cash and short-term investments as at September 30, 2005, amounted to approximately NIS 4.16 billion, compared with approximately NIS 2.57 billion on September 30, 2004. The increase derives mainly from the cash flow from operating activities in the principal segments in which the Group operates (excluding multi-channel television), and from an offering of debentures and loans raised. The increase was moderated as a result of repayment of long-term loans and the acquisition of fixed assets.

2. Results of Operations

A. Principal results

Net earnings for the first nine months of 2005 amounted to approximately NIS 547 million, compared with net earnings of approximately NIS 517 million for the corresponding period in the prior year. The difference in the results derives mainly from differences in the period in which Pelephone and DBS were consolidated in the period of account compared with the corresponding period in the prior year, and from changes in the operating income of the Group companies, as well as Other revenues (expenses) in the Company, as described below.

Below are details of the changes in the results of the segments compared to the corresponding period (not including Other income / expenses, net).

<u>Segment</u>	For the nine-month period ended	
	September 30	
	2005	2004
	<u>NIS millions</u>	<u>NIS millions</u>
Fixed-line domestic communications	681	782
Cellular ⁽¹⁾	384	257
International communications and internet services	69	93
Multi-channel television ⁽²⁾	(79)	(33)
Others	(2)	9

Net earnings per share for the first nine months of 2005 amounted to NIS 0.21 per NIS 1 par value, compared with net earnings per share of NIS 0.198 per NIS 1 par value in the corresponding period in the prior year.

B. Revenues

Group revenues in the first nine months of 2005 amounted to approximately NIS 8.34 billion compared with earnings of approximately NIS 6.49 billion in the corresponding period in the prior year. The increase of approximately NIS 1.99 billion derives from first-time consolidation implemented during 2004. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 3.75 billion in the first nine months of 2004 to approximately NIS 3.57 billion during the period of account (a decrease of approximately 4.9%). Most of the decrease in the segment's revenue derived from a tariff reduction in June 2004 and June 2005, a decrease in call and internet dial-up traffic, a decrease in revenues from the sale of equipment to subscribers, and a decrease in royalties received from Pelephone. The decrease in revenues was moderated by the ongoing

⁽¹⁾ First-time full consolidation.

⁽²⁾ First-time consolidation.

growth in the number of customers who subscribe to high-speed internet service (ADSL). The auditors drew attention to the ongoing opening of the communications industry to competition and to expected tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 1.86 billion in the first nine months of 2004 to approximately NIS 3.35 billion during the period of account, mainly as a result of the effect of the first-time full consolidation implemented during 2004. In addition, the segment's revenues increased as a result of an increase in revenues from sales of terminal equipment to customers and from terminal equipment services. Amendment of the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1, 2005 eliminated almost completely the upward trend in the segment's revenues despite the increase in the number of customers.

Revenues from the international communications and internet services segment decreased from approximately NIS 614 million in the first nine months of 2004 to approximately NIS 604 million during the period of account. The decrease derives mainly from a decrease in revenues from outgoing calls due to a significant decrease in traffic and in the outgoing call tariffs as a result of greater competition. This decrease was offset by a considerable increase in the routing of international call traffic and in internet revenues, which derived from a rise in the number of high-speed internet customers.

Revenues in the multi-channel television segment increased from approximately NIS 269 million in the first nine months of 2004 to approximately NIS 896 million in the period of account, mainly due to the consolidation of DBS during the course of 2004. In addition, there has been an increase in revenues in this segment compared with the corresponding period as a result a net increase of approximately 56,000 in the number of net subscribers and an increase in the average revenue per subscriber from new services.

C. General and operating expenses

The Group's general and operating expenses for the first nine months of 2005 amounted to approximately NIS 5.34 billion compared with approximately NIS 3.73 billion during the corresponding period in the prior year. Approximately NIS 1.5 billion of the increase derives from first-time consolidation.

In the fixed-line domestic communications segment, general and operating expenses increased from approximately NIS 1,728 million in the first nine months of 2004 to approximately NIS 1,733 million during the period of report. The increase derives mainly from a rise in the costs of vehicle and building maintenance and a decrease in salaries charged to fixed assets which was set off by a decrease in material consumption expenses and general expenses.

In the cellular segment, general and operating expenses increased from approximately NIS 1,376 million in the first nine months of 2004 to approximately NIS 2,506 million during the period of account, due mainly from the first-time full consolidation. In addition, expenses in the segment increased compared with the corresponding period mainly due to increased revenues and subscriber acquisition costs which derive from winning the tender of the Accountant General at the Ministry of Finance. The increase was offset by a decrease in marketing expenses.

In the international communications and internet services segment, there was an increase in general and operating expenses from approximately NIS 426 million in the first nine months of 2004 to approximately NIS 460 million during the period of account, resulting from the increase in foreign managers expenses deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator.

In the multi-channel television segment, general and operating expenses increased from approximately NIS 228 million in the corresponding period to approximately NIS 733 million during the period of account, mainly due to the consolidation of DBS during 2004. In addition, expenses increased in the segment due to the increase in subscribers which resulted in increased content and other operating expenses.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 1,495 million in the first nine months of 2004 to approximately NIS 1,749 million during the period of account, resulting from the first-time consolidation in respect of which depreciation expenses increased by approximately NIS 321 million. Eliminating this increase, depreciation expenses decreased as a result of fully depreciated fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment and the international communications and internet services segment.

E. Royalties to the Government of Israel

The Group's royalties expenses amounted to approximately NIS 195 million compared with NIS 156 million during the corresponding period in the prior year. The source of the increase is the first-time consolidation referred to above.

F. Operating income

The Group's operating income in the first nine months of 2005 amounted to approximately NIS 1,053 million, compared with NIS 1,108 million during the corresponding period in the prior year, a decrease of approximately NIS 55 million. The decrease in operating income derives from the changes in the results of the revenues and expenses sections of the segments described above. These changes led to a reduction in the profitability of the Group's main segments of operation (except for the multi-channel television segment). The Group's operating income was partially influenced by the first-time consolidation of DBS's financial results and the full consolidation of Pelephone's financial results as described above.

G. Financing expenses

The Group's net financing expenses for the first nine months of 2005 amounted to approximately NIS 272 million compared with approximately NIS 137 million during the corresponding period in the prior year. Approximately NIS 133 million of the expenses derives from the first-time consolidation.

The effect of the changes in foreign currency and shekel rates on the Company's liabilities were partially neutralized by hedging transactions carried out, and by investment in financial assets.

The Group's financing expenses were influenced by income from the capital markets as a result of investments in marketable securities, and by an increase in exchange rates and the consumer price index.

H. Other income (expenses)

Income amounting to approximately NIS 131 million was recorded in the Group's Other income (expenses) item, compared with income of approximately NIS 109 million during the corresponding period in the prior year.

Most of the income in the corresponding period was a reduction in the provision for early retirement. The income recorded in the period of account derives mainly from capital gains of approximately NIS 109 million and a reduction of approximately NIS 83 million in the provision for early retirement (due to transfer to an insurance company). The income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 10 to the financial statements).

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates during the first nine months of 2005 amounted to approximately NIS 13 million compared with losses of approximately NIS 131 million recorded during the corresponding period in the prior year. Most of the decrease during the period of account derives from DBS becoming a consolidated company during 2004, and the results of its operations are presented in the financial statements on a consolidated basis, rather than by the equity method (see Note 4 to the financial statements).

The Company's auditors drew attention to the financial condition of DBS, and to the fact that its continued operation is contingent upon arranging its sources of finance for next year. In the opinion of DBS's management, based on, *inter alia*, its work plan for the year 2006, there are reasonable changes of arranging the sources of finance that will be required by DBS in the coming year, including the completion of the amounts required pursuant to the work plan.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first nine months of 2005 amounted to approximately NIS 1,807 million, compared with approximately NIS 2,027 million during the corresponding period in the prior year. Eliminating an increase of approximately NIS 297 million which derives from first-time consolidation, cash flows from operating activities decreased by approximately NIS 517 million. The decrease derived mainly from the fixed-line domestic communications and cellular segments, and was mainly due to changes in the assets and liabilities items. Additionally, the decrease in the earnings from operating activities in those segments contributed further to the decrease in cash flows from operating activities.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the period of report included, *inter alia*, approximately NIS 1,331 million in the development of communications infrastructure and approximately NIS 717 million in short-term investments.

During the period, the Group repaid approximately NIS 1,440 in debts, of which approximately NIS 1,258 million was on account of long-term loans and approximately NIS 182 million was on account of debentures.

The Group raised new debt in a total amount of approximately NIS 2,165 million by an issuance of debentures and receipt of new long-term loans and short-term credit.

The average monthly short-term credit during the period was approximately NIS 106 million. The average monthly long-term liabilities for the period was approximately NIS 8,691 million.

Working capital as at September 30, 2005, was positive and amounted to approximately NIS 1,784 million, compared with negative working capital of approximately NIS 1,314 million on September 30, 2004. The increase derives mainly from an improvement in working capital in the multi-channel television segment, in the amount of approximately NIS 1,287, as a result of changes in credit terms.

In the cellular segment, working capital improved by approximately NIS 788 million, most of which derived from an increase in cash and short-term investments designated for the gradual repayment of bank loans. In addition, current liabilities decreased mainly due to a decrease in trade payables.

In the fixed-line domestic communications segment working capital improved by approximately NIS 867 million compared with September 30, 2004, as a result of an increase in cash and short-term investments.

4. Comparison of the results of the third quarter of 2005 with the results of the corresponding quarter last year

The following are details of the changes in the results of segments in comparison with the corresponding period (not including Other income/expenses, net):

<u>Segment</u>	For the three-month period ended	
	September 30	
	2005	2004
	<u>NIS millions</u>	<u>NIS millions</u>
Fixed-line domestic communications	225	231
Cellular ⁽¹⁾	130	117
International communications and internet services	26	27
Multi-channel television ⁽²⁾	(29)	(33)
Others	(2)	4

(1) First-time full consolidation.

(2) First-time consolidation.

Revenue during the third quarter of 2005 increased by approximately NIS 365 million compared with the corresponding quarter in the prior year. The increase derived mainly from the full consolidation of Pelephone.

Operating and general expenses increased by approximately NIS 325 million compared with the corresponding quarter in the prior year. An increase of approximately NIS 270 million derives from the first-time consolidation of Pelephone. In addition, the increase also derives from the increase in the operating and general expenses recorded mainly in the cellular and multi-channel television segments.

The results of the third quarter in comparison with the corresponding quarter in the prior year were influenced mainly by the Other expenses/income item due to recording income of approximately NIS 145 million in the corresponding period, which derived from a reduction in the provision in respect of employees' claims.

Financing expenses during the third quarter of 2005 increased by approximately NIS 39 million compared with the corresponding quarter in the prior year. The increase was mainly due to the first-time consolidation.

The behavior of the various income and expense items and the causes of the differences between the quarters are similar to the explanations set out in the results of the period.

The changes described above in the items of the statements of operations brought about net earnings of approximately NIS 103 million in the third quarter, compared with net earnings of approximately NIS 243 million in the corresponding quarter of the prior year.

5. Group involvement in the community and donations

During the period of the account, the Company was active in the community through its involvement in social institutions and organizations such as the education system in distressed areas and the confrontation line.

As part of the campaign launched by the Company to mark the twentieth anniversary of its establishment, the Company made donations to various organizations during the 12 months commencing February 20, 2004. The amount of the monthly donation was the higher of 5% of its call revenues on the twentieth day of each month of its anniversary year, or NIS 200,000. During the period of account the Company donated NIS 231,000 and overall throughout the campaign, a total of NIS 2,792 thousand.

In the "Summer for the Community" campaign, initiated by the Company for the second consecutive year, the teenage children of employees worked during the summer in medical institutions and community centers. The cost of the project to the Company was approximately NIS 1 million.

6. Details concerning exposure to and management of market risks

- A. Further to that described in the Directors' Report for 2004, as a result of hedging transactions against market risks relating to exposure in changes of exchange rates, the Group incurred no material financing expenses or income during the period of report.
- B. The report of positions of derivatives as at September 30, 2005, is not significantly different from the report as at December 31, 2004.
- C. The report on linkage bases as at September 30, 2005, is not significantly different from the report as at December 31, 2004.

Surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at September 30, 2005, amounted to approximately NIS 2.6 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at September 30, 2005, amounts to approximately NIS 503 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at September 30, 2005, amount to approximately NIS 4.6 billion in the Group.

7. Utilization of proceeds from securities

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

8. Miscellaneous

A. Adoption of a Code of Ethics

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

B. Peer Review

On July 20, 2005, a directive was published by the Securities Authority requiring disclosure regarding the provision of consent for the performance of a "peer review", the purpose of which, as set out in the directive, is to commence the process of monitoring the performance of accountancy firms. The directive raises questions, including legal issues mainly as to the confidentiality of the material transferred to accountants, and the damage that might be caused to the Company as a result of disclosure of such information. In light of this, the Company, together with its legal counsel, is assessing the matter, including methods of solving the problem of confidentiality, and will present its recommendations for the discussion and approval of the Board.

C. Sale of the Controlling Share

On October 11, 2005, the sale of the controlling interest in the Company and the transfer of the State's share holding to Ap.Sb.Ar. Holding Ltd. was completed. See note 1(f) to the financial statements. With the completion of the transaction, all directors serving on behalf of the State resigned from the Board of Directors and the appointment of the new directors took effect. The new directors were previously approved by the general meeting of shareholders. The external directors who served prior to the completion of the transaction continue to serve on the Board.

D. Directors with Accounting and Financial Skills

Current serving directors with accounting and financial skills are: Yigal Cohen Orgad (external director), Adam Chesnoff, Menachem Inbar, and Stephen Grabiner.

E. Chairman of the Board and Chief Executive Officer

On October 11, 2005, Mr. Moshe Arkin began serving as Chairman of the Board of Directors and Mr. Yacov Gelbard as Chief Executive Officer.

Moshe Arkin
Chairman of the Board

Yacov Gelbard
Chief Executive Officer

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2005

Interim Consolidated Financial Statements as at September 30, 2005

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

Dear Sirs,

**Re: Review of the Unaudited Condensed Interim Consolidated Financial Statements as
at September 30, 2005**

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunications Corp. Limited (hereinafter "Company") as at September 30, 2005, as well as the condensed interim consolidated statements of operations, the condensed interim statements of changes in shareholders' equity and the condensed interim consolidated statements of cash flows for the three and nine-month periods then ended.

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

Reports of other auditors were furnished to us which relate to the review of the condensed interim financial statements of consolidated subsidiaries, whose assets as at September 30, 2005, constitute approximately 37% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 60% of the total revenues included in the condensed interim consolidated statement of operations for the nine-month period then ended and approximately 63% of the total revenues included in the condensed interim consolidated statement of operations for the three months then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in which the Company's investments amount to approximately NIS 65 million as at September 30, 2005, and the Company's share in the losses in respect thereof amount to approximately NIS 13 million and approximately NIS 2 million for the nine and three-month periods then ended.

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



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

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

1. The continuing opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for early retirement, as described in Note 5.
3. Contingent claims made against the Company and against invested companies, as described in Note 6A.
4. The financial position of a consolidated company. As mentioned in Note 4, the continuation of the operations of the consolidated company is dependent upon the arrangement of sources of finance required for the forthcoming year. In the opinion of the management of the consolidated company, based on, among others, the 2006 work plan, the chances of arranging sources of finance required by the consolidated company in the forthcoming year are good, including completion of receipt of the amounts required according to the work plan.

Somekh Chaikin
Certified Public Accountants (Isr.)

November 16, 2005

Condensed Interim Consolidated Balance Sheets as at

Reported amounts

	September 30 2005 (Unaudited) <u>NIS thousands</u>	September 30 2004 (Unaudited) <u>NIS thousands</u>	December 31 2004 (Audited) <u>NIS thousands</u>
Current assets			
Cash and cash equivalents	2,090,898	1,313,837	1,457,107
Short-term investments	2,067,668	1,254,967	1,287,809
Trade receivables	2,139,566	2,147,714	2,115,070
Other receivables and debit balances	305,185	418,610	416,113
Inventory	256,685	254,353	314,549
	<u>6,860,002</u>	<u>5,389,481</u>	<u>5,590,648</u>
Materials and spare parts	<u>122,269</u>	<u>139,704</u>	<u>130,922</u>
Broadcasting rights, net	<u>161,335</u>	<u>128,410</u>	<u>140,496</u>
Investments and long-term receivables			
Investments, deposits and debit balances	858,224	876,076	872,575
Investments in investee companies	64,795	61,967	70,308
	<u>923,019</u>	<u>938,043</u>	<u>942,883</u>
Fixed assets			
Cost	34,606,992	35,607,803	34,311,281
Less– accumulated depreciation	24,486,246	24,888,542	23,570,947
	<u>10,120,746</u>	<u>10,719,261</u>	<u>10,740,334</u>
Other assets			
Goodwill	1,722,820	1,834,529	1,792,658
Deferred charges and other assets	390,807	393,956	387,904
Deferred taxes	349,420	450,447	446,136
	<u>2,463,047</u>	<u>2,678,932</u>	<u>2,626,698</u>
	<u>20,650,418</u>	<u>19,993,831</u>	<u>20,171,981</u>

	September 30 2005 (Unaudited) <u>NIS thousands</u>	September 30 2004 (Unaudited) <u>NIS thousands</u>	December 31 2004 (Audited) <u>NIS thousands</u>
Current liabilities			
Bank credit	124,864	1,321,527	88,102
Current maturities of:			
Long-term bank loans	1,322,361	1,407,591	1,304,916
Debentures	553,138	230,513	240,481
Trade payables	1,259,006	1,597,310	1,675,569
Employee severance benefits	479,066	696,644	592,474
Other current liabilities	1,337,273	1,449,414	1,402,140
	<u>5,075,708</u>	<u>6,702,999</u>	<u>5,303,682</u>
Long-term liabilities			
Long-term loans	2,176,640	1,633,409	2,860,934
Debentures	4,902,956	3,663,469	3,824,539
Employee severance benefits	448,206	607,058	680,096
Other long-term liabilities	33,982	37,093	47,375
Loans, net, extended by the minority in a consolidated company:			
Loans	1,102,949	1,051,620	1,057,988
Less – minority share in deficit of a consolidated company	<u>(1,102,949)</u>	<u>(1,051,620)</u>	<u>(1,057,988)</u>
	<u>7,561,784</u>	<u>5,941,029</u>	<u>7,412,944</u>
Minority rights	–	(12,012)	(10,412)
Contingent liabilities (Note 6)			
Shareholders' equity	<u>8,012,926</u>	<u>7,361,815</u>	<u>7,465,767</u>
	<u><u>20,650,418</u></u>	<u><u>19,993,831</u></u>	<u><u>20,171,981</u></u>

Moshe Arkin
Chairman of the Board

Yacov Gelbard
Chief Executive Officer

Ron Eilon
Deputy CEO and CFO

Date of approval of the financial statements: November 16, 2005.

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

Condensed Interim Consolidated Statements of Operations

Reported amounts

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues (Note 8)	8,339,217	6,494,244	2,838,719	2,473,463	9,269,804
Costs and expenses					
General and operating expenses (Note 9)	5,341,136	3,734,934	1,835,484	1,510,954	5,565,090
Depreciation	1,749,207	1,495,079	587,890	556,290	2,092,475
Royalties to the Government of Israel	195,490	155,835	65,319	59,774	220,691
	7,285,833	5,385,848	2,488,693	2,127,018	7,878,256
Operating income	1,053,384	1,108,396	350,026	346,445	1,391,548
Financing expenses, net	(272,449)	(136,625)	(107,370)	(67,878)	(217,529)
Earnings after financing expenses	780,935	971,771	242,656	278,567	1,174,019
Other income (expenses), net (See Note 10)	130,654	108,939	(22,088)	131,940	79,680
Earnings before income tax	911,589	1,080,710	220,568	410,507	1,253,699
Income tax	(375,294)	(433,098)	(115,471)	(166,320)	(497,485)
Earnings after income tax	536,295	647,612	105,097	244,187	756,214
Equity in losses of affiliates	(13,107)	(130,695)	(1,940)	(1,365)	(134,773)
Minority share in losses (earnings) of subsidiaries	8,971	(44)	(8)	(172)	(616)
Earnings before the cumulative effect of a change in accounting method	532,159	516,873	103,149	242,650	620,825
Cumulative effect of a change in accounting method as at the beginning of the year*	15,000	–	–	–	–
Net earnings	547,159	516,873	103,149	242,650	620,825
Primary and diluted earnings per NIS 1 par value of common shares (in NIS):					
Earnings before the cumulative effect of a change in accounting method	0.205	0.198	0.039	0.093	0.238
Cumulative effect of a change in accounting method	0.005	–	–	–	–
Net earnings per share	0.210	0.198	0.039	0.093	0.238

* See Note 2B.

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

Condensed Interim Statements of Changes in Shareholders' Equity

Reported amounts

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Retained earnings (deficit)	Total
	NIS thousands				
Nine months ended September 30, 2005					
Balance as at December 31, 2004 (audited)	6,309,133	1,623,423	37,775	(504,564)	7,465,767
Net earnings (unaudited)	–	–	–	547,159	547,159
Balance as at September 30, 2005 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>42,595</u>	<u>8,012,926</u>
Nine months ended September 30, 2004					
Balance as at December 31, 2003 (audited)	6,309,133	1,623,423	37,775	(1,125,389)	6,844,942
Net earnings (unaudited)	–	–	–	516,873	516,873
Balance as at September 30, 2004 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>(608,516)</u>	<u>7,361,815</u>
Three months ended September 30, 2005					
Balance as at July 1, 2005 (unaudited)	6,309,133	1,623,423	37,775	(60,554)	7,909,777
Net earnings (unaudited)	–	–	–	103,149	103,149
Balance as at September 30, 2005 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>42,595</u>	<u>8,012,926</u>
Three months ended September 30, 2004					
Balance as at July 1, 2004 (unaudited)	6,309,133	1,623,423	37,775	(851,166)	7,119,165
Net earnings (unaudited)	–	–	–	242,650	242,650
Balance as at September 30, 2004 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>(608,516)</u>	<u>7,361,815</u>
Year ended December 31, 2004					
Balance as at December 31, 2003 (audited)	6,309,133	1,623,423	37,775	(1,125,389)	6,844,942
Net earnings (audited)	–	–	–	620,825	620,825
Balance as at December 31, 2004 (audited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>(504,564)</u>	<u>7,465,767</u>

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

Condensed Interim Consolidated Statements of Cash Flows

Reported amounts

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Cash flows from operating activities					
Net earnings	547,159	516,873	103,149	242,650	620,825
Adjustments to reconcile net earnings to net cash flows from operating activities (see A below)	1,259,954	1,509,844	400,347	315,641	2,229,157
Net cash generated by operating activities	1,807,113	2,026,717	503,496	558,291	2,849,982
Cash flows from investing activities					
Investment in fixed assets	(1,330,827)	(997,465)	(347,247)	(319,762)	(1,650,557)
Proceeds from disposal of fixed assets and sale of operations	144,528	73,629	18,988	30,966	131,576
Investment in long-term deposits and investments	(7,218)	(29,085)	(236)	(995)	(42,064)
Realization of long-term deposits and investments	93,239	36,313	84,630	391	18,094
Decrease (increase) in short-term investments, net	(717,270)	143,390	(527,234)	(38,802)	135,602
Decrease (increase) in materials and spare parts	(5,552)	(40,066)	28,264	6,335	625
Acquisition of companies consolidated for the first time (see C below)	–	(246,935)	–	(246,935)	(246,935)
Investment in investee companies	(6,474)	(108,594)	(728)	(465)	(142,753)
Investment in other assets	(68,872)	(107,300)	(29,430)	(36,876)	(130,700)
Net cash used in investing activities	(1,898,446)	(1,276,113)	(772,993)	(606,143)	(1,927,112)
Cash flows from financing activities					
Issue of debentures (after deduction of issue expenses)	1,702,265	1,426,215	464,029	105,921	1,528,092
Repayment of other debentures	(182,108)	(573,467)	(61,801)	(29,186)	(601,481)
Receipt of long-term loans	442,000	189,500	24,500	50,000	314,900
Repayment of long-term loans	(1,257,767)	(2,312,951)	(205,321)	(1,941,725)	(2,605,012)
Receipt (repayment) of short-term bank credit, net	20,734	(120,414)	19,685	(23,254)	(56,612)
Net cash generated by (used in) financing activities	725,124	(1,391,117)	241,092	(1,838,244)	(1,420,113)
Increase (decrease) in cash and cash equivalents	633,791	(640,513)	(28,405)	(1,886,096)	(497,243)
Balance of cash and cash equivalents at the beginning of the period	1,457,107	1,954,350	2,119,303	3,199,933	1,954,350
Balance of cash and cash equivalents at the end of the period	2,090,898	1,313,837	2,090,898	1,313,837	1,457,107

The notes to the financial statements are integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows (Contd.)

Reported amounts

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
A – Adjustments to reconcile net earnings to net cash flows from operating activities					
Revenue and expenses not involving cash flows:					
Depreciation	1,749,207	1,495,079	587,890	556,290	2,092,475
Deferred taxes	132,212	40,273	58,462	38,469	219,975
Company's equity in losses of affiliated companies	13,107	130,695	1,940	1,365	134,773
Minority share in earnings (losses) of a consolidated subsidiary	(8,971)	44	8	172	616
Decrease in employee severance benefits, net	(345,298)	(79,202)	(230,138)	(19,418)	(110,334)
Loss (gain) on disposal of fixed assets	(5,346)	(7,143)	(2,597)	(7,539)	(7,338)
Provision for decrease in value of investments	5,868	–	1,168	–	26,000
Gain from sale of operations	(103,869)	–	–	–	(35,033)
Appreciation (erosion) and interest on long-term deposits and investments	14,881	(12,238)	1,735	7,420	31,199
Appreciation of short-term investments, net	(62,589)	(5,530)	(35,927)	(15,675)	(10,584)
Appreciation (erosion) of long-term liabilities:					
Debentures	(129,083)	18,499	(10,668)	16,760	115,674
Long-term loans and other liabilities	152,841	5,028	76,783	(39,897)	(17,104)
Amortization of other assets and deferred expenses	143,361	76,102	47,637	32,184	110,083
Changes in asset and liability items:					
Increase in broadcasting rights	(20,839)	(5,430)	(1,721)	(5,430)	(17,516)
Decrease (increase) in trade receivables	(98,673)	40,031	(84,155)	37,431	52,827
Decrease (increase) in other receivables and debit balances	39,888	121,551	63,841	39,422	(8,223)
Decrease (increase) in inventory	43,040	(58,593)	23,937	4,159	(122,824)
Decrease in trade payables	(218,029)	(204,542)	(48,759)	(88,679)	(102,466)
Increase (decrease) in other current liabilities	(28,361)	(29,992)	(52,679)	(241,689)	(126,652)
Increase (decrease) in deferred revenues	(13,393)	(14,788)	3,590	296	3,609
	1,259,954	1,509,844	400,347	315,641	2,229,157

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

Condensed Interim Consolidated Statements of Cash Flows (Contd.)

Reported amounts

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
B– Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	<u>133,125</u>	<u>119,488</u>	<u>133,125</u>	<u>119,488</u>	<u>102,687</u>
Sale of fixed assets on credit	<u>–</u>	<u>1,993</u>	<u>–</u>	<u>1,993</u>	<u>1,196</u>
C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company					
Working capital (excluding cash and cash equivalents)	–	2,057,632	–	171,938	2,057,632
Fixed assets	–	(2,967,819)	–	(1,763,768)	(2,967,819)
Long-term liabilities	–	2,322,740	–	2,391,877	2,322,740
Minority loans to the subsidiary	–	1,048,637	–	–	1,048,637
Less minority share in the deficit	–	(1,048,637)	–	–	(1,048,637)
Minority rights	–	(16,549)	–	–	(16,549)
Investment in an affiliate	–	178,339	–	(2,215)	178,339
Goodwill	–	(1,821,278)	–	(1,044,767)	(1,821,278)
	<u>–</u>	<u>(246,935)</u>	<u>–</u>	<u>(246,935)</u>	<u>(246,935)</u>

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

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL

- A. These interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim periods pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB) and according to the provisions of Chapter 4 of the Securities Regulations (Periodic and Immediate Reports) 5730-1970.
- B. These statements should be read in conjunction with the annual financial statements of the Company and its consolidated companies as at December 31, 2004, and for the year then ended, and the accompanying notes thereto (hereinafter – the Annual Reports).
- C. The Company presents in the notes to the interim financial statements only those significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of domestic fixed-line communication services, cellular telephone services, international communication services, multi-channel television services and the opening of these markets to competition and relating to the sale of the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2004. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:
- (1) On April 10, 2005, a copy of a letter of the Director General of the Ministry of Communications dated April 6, 2005, was forwarded to the Company. The letter is addressed to the Director of the Government Companies Authority and contains clarifications for the participants in the privatization process of the Company. According to the letter, the clarifications therein are in response to the principal issues raised by the participants in the privatization process, based on the present policy of the Ministry for the promotion of competition in the communications sector and on the provisions of the law and the existing licenses, and they should not be seen as grounds for any expectation or reliance thereon, on the part of the participants. The clarifications relate, *inter alia*, to the following issues: the policy for licensing the provision of telephony services by means of broadband access (VOB) (Voice Over Broadband); the Company's tariffs and volume discounts; baskets of services; interconnect payments; royalties; structural separation; universal service; the Communications Order; the use of ADSL by the subsidiary DBS for providing its services; minimum payment for making a cellular call; fixed-mobile convergence and number portability. In the opinion of the Company, the clarifications contained in the Director General's letter do not significantly reduce the regulatory uncertainty in which the Group and the Company operate. Furthermore, the letter also refers in a general way to future actions which the Company is unable to assess, at this stage, whether and when they will occur, and is also, therefore, unable to assess their effect on the activities of the Company and the subsidiaries in the Group and on their financial results.
 - (2) Further to Note 1E(1)e. to the financial statements as at December 31, 2004, concerning a policy paper for "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator", on April 20, 2005, the Ministry of Communications informed, *inter alia*, the Company and its subsidiaries that in completing preparation of the policy and after examining the remarks submitted in response to their request, it was considering amending the policy paper so as to allow the Company or one of its subsidiaries to provide VOB services once the Company's market share in fixed-line domestic telephony falls in certain customer segments below 85%. In addition, the Ministry intends to set two review dates, in November 2006 and November 2007, to examine the possibility of permitting the Company or one of its subsidiaries to provide VOB services even if the Company has not lost 15% of its market share, noting the developments in competition in telephony. The Company sees the aforementioned amendment as a possible deterioration of opportunities for itself and for its subsidiaries and informed the Ministry of Communications of its opposition to the policy paper. The Company clarified, *inter alia*, that Bezeq should not be denied the ability to provide VOB services, in that such denial would run counter to the license and the law, would be unprecedented anywhere in the world and would be seriously harmful to the Company and its customers.

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL (CONTD.)

C. (2) (contd.)

In addition, amendment of that policy would prevent Bezeq International (as a subsidiary of the Company) from providing VOB services and could force Bezeq International out of this developing market, thereby granting its competitors a clear competitive advantage in internet access services and international communication (most of which have received a marketing trial license from the Ministry of Communications for the provision of these telephony services and one of which has also applied for a special general license for providing broadband telephony services), in that they will offer their customers a total communications solution that combines Internet access, international telephony and fixed-line domestic services. In the opinion of Bezeq International, its inability to offer a similar total solution is liable to cause its existing customers to leave in favor of the services of its competitors and to make it difficult to recruit new customers. Bezeq International is unable to estimate, at this stage, the effects of the above, if any, on the results of its operations and its financial position. The matter is currently going through a hearing process with the Ministry of Communications and the Company and its subsidiaries are preparing for such process.

- (3) Regarding marketing trial licenses for payment for fixed-line services over the Internet (VOIP), after joint discussion at the Ministry of Communications with the Company and operators who wish to offer this service, the Ministry of Communications issued an administrative directive for the operation of dialing directions and number ranges allocated for the use of the marketing trial licensees on the Company's network. In an additional letter of the Ministry of Communications it was clarified that the Company will not bear "expenses in kind" of the trial, and that to the extent that additional payment is determined as part of VOB policy, that payment will also apply retroactively to the trial period. As at the date of publication of these financial statements, dialing directions have been opened for two licensees (one of which is the subsidiary Bezeq International), and the Company is in contact with other holders of the trial licenses for connection to its network. In response to notification that a marketing trial license for VOIP services had been granted to a competing cellular company, the Company requested that the Ministry of Communications delay the license, as far as is possible, at least until the end of the hearing proceedings and the determination of the policy. As at the date of publication of the financial statements, the Ministry of Communications has not replied to the Company.
- (4) Further to Note 1E(1)f. to the financial statements as at December 31, 2004, concerning the arrangement whereby interconnect fees will not be paid for terminating a call between the networks of the Company and a domestic operator ("HOT"), on April 14, 2005, the Company withdrew its appeal to the Supreme Court.
- (5) Further to Note 1E(1)g. to the financial statements as at December 31, 2004, concerning number portability, on March 29, 2005, the Economic Policy for Fiscal Year 2005 Law (Legislative Amendments), 5765-2004 was passed by the Knesset. The law includes, among others, an amendment to the Communications Law (Telecommunications and Broadcasting), 5742-1982, whereby the Minister of Communications will prepare a numbering program for the matter of number portability regarding a holder of a general license (including a special general license) for fixed-line domestic communication and regarding the holder of a general license for the provision of cellular services and will instruct them concerning its implementation and operation by September 1, 2006. (If the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone by an order and with the approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months.)

On August 22, 2005, the Ministry of Communications signed a numbering plan for recording number portability, the main points of which are these:

- a. A licensee must install and operate all the means required for number portability in its systems no later than April 30, 2006, complete the tests between it and other licensees no later than July 31, 2006, and provide number portability on demand on the date prescribed
- b. in the law (September 1, 2006, subject to a possible extension of that date by three months).

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL (CONTD.)

C. (5) (contd.)

- b. The implementation of number portability will be possible among licensees who operate in the same segment of operations (among cellular operators) and among licensees for domestic fixed-line communications, in the same type of dial area only).
- c. The determination of directives in the matter of routing the call of a subscriber who has changed service provider, the recording process for a portability request, updating the portability request and changing the service provider, as well as provisions relating to quality of service.

In a letter accompanying the numbering plan, the Ministry of Communications wrote that the plan is a general and basic regulatory framework outlining the duties imposed on the licensees for the application of the provisions of the law on the matter of number portability. However, the Ministry will reconsider the need to revise the plan from time to time, in accordance with the progress of the implementation plans and the existence of other matters that will necessitate the Ministry's intervention. The letter also states that claims of operators concerning the period of time set for the updating process (three to four hours) were not accepted. Nevertheless, should an operator make a request to try to convince the Ministry that the process cannot reasonably be accomplished in the time defined, or that unreasonable investments are required for another alternative within the time-frame prescribed in the law (one day), the Ministry will consider such a request.

As the Company noted in its reports and in its position sent to the Ministry, the timetables set for the implementation of the plan are impossible to meet (the signed numbering plan extended by only three months the interim dates – milestones for the planning and installation of the means for operating number portability, but the timetable for the commencement of number portability deriving from the law remains largely as was). Furthermore, in the opinion of the Company, the implementation of number portability could necessitate considerable financial investments in the replacement of software and hardware versions in the Company's switching network. Substantial investment will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. In addition, operation of number portability involves costs relating to joint recording and management with the relevant operators, the full extent of which cannot yet be assessed. In addition to the costs already expected, the implementation of number portability, while facilitating customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the ability of the Company and of the other companies in the Group to compete.

The Company is studying the signed plan as compared to the draft plan and intends to continue its efforts, *inter alia*, to convince the Ministry of the need to set a more reasonable timetable.

On August 31, 2005, the Company again notified the Minister of Communications that it is preparing to implement number portability and is investing the required resources, but that the dates were unrealistic and the Company would not be able to comply with them. The Company again requested that it be invited for discussions so that it may show the Ministries of Communications and Finance the actions it is taking and the reasons for non-compliance with the timetable.

- (6) On July 14, 2005, the general license of the Company and the licenses of other operators were amended. The amendment to the Company's license states that it will operate in accordance with the Israeli standard which deals with reliability of charging and proper disclosure in telephone bills. According to the amendment, the provisions of the standard concerning proper disclosure in telephone bills will come into force by October 14, 2005, while the provisions relating to reliability of charging will come into force by January 14, 2006.

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL (CONTD.)

C. (6) (contd.)

The Company's license was amended as aforesaid even though the Company submitted its position to the Ministry that there was no justification for the standard in the proposed format and certainly not for turning it, by adoption into the license, into a binding standard. The Company also stated that application of the standard involves considerable investment of resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be effected simultaneously with the implementation of the number portability plan, and that it will need a longer timeframe for application of the standard.

The Company is prepared to apply the standard in accordance with the amendment to its license, but applied concurrently to the Ministry of Communications and notified that it will not be able to achieve the dates set for application of the standard in accordance with the amendment to its license, and requested that it present the matter before the Ministry so that the Ministry could re-examine the Company's request to allow it a longer period for preparation.

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

- (8) Further to Note 1E(1)(a) to the financial statements as at December 31, 2004, concerning updates to the Company's tariffs:

- a. On May 5, 2005, the Company received a letter from the Director General of the Ministry of Communications dated May 4, 2005, which was sent to the Director General of the Government Companies Authority, the subject of which was amendment to the Communications Regulations (Calculation and linkage of payments for telecommunications services), 5763-2003 ("the Regulations"), which set out the mechanism for annual updating applicable to the controlled tariffs of the Company. In the course of dealing with the annual update of the Company's tariffs, professional persons at the Ministry of Communications became aware that a certain minor modification was required to the method of calculation described in the Regulations, so as to enable more precise measurement of the data used in calculating the annual efficiency factor.

The immediate effect of the adjustment will reduce the revenues of the Company by approximately NIS 30 million per year in each of the years of the arrangement (through the end of 2007). Beyond that, the effects of the adjustment applicable from the June 2006 update could significantly increase the reduction to Company revenues, to the extent that the change in the formula of the calculation results in a higher efficiency factor in the subsequent updates, which apply from June 2006 to the end of the arrangement period.

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL (CONTD.)

C. (8) (contd.)

- b. On June 1, 2005, the controlled tariffs of the Company were reduced by an average of about 2.2%. The reduction is based on a change of approximately 1.2% in the Consumer Price Index and an average efficiency factor of approximately 3.4%. It should be noted that the update includes, *inter alia*, a reduction of approximately 3.2% in call tariffs and an increase of approximately 1.2% in fixed fees. The reduction also included the adjusted method of calculation as explained above. It is noted that the interconnect tariffs were reduced by 3.2% commencing September 1, 2005.

Following the lowering of VAT to 16.5% in September 2005, the Company's tariffs were updated accordingly. Subsequently, minor adjustments were made to some of the Company's tariffs (and published in the Tariff Regulations), effective from November 1, 2005, so that the tariffs of the various services would remain in whole figures when including the new VAT rate.

- (9) Further to Note 1E(2)b., during the third quarter of 2005 a hearing was held, both orally and written, on the intention to modify the structure of the tariff to the consumer for cellular calls, so that commencing on a reasonable date to be determined, there will be no difference in the price of a call within the network and a call from one cellular network to another, and the price will include the interconnect component. No decision has been made on the matter as yet by the Ministries of Communications and Finance.

- D. On May 3, 2005, a collective agreement was signed, whereby the Company will pay its employees, subject to and after completion of transfer of the State's holdings to the Buyer as set out in the sale procedure, a one-time bonus in the amount of half of the wage cut pursuant to the Economic Plan Law and a collective agreement for encouraging economic growth, in respect of the period from August 28, 2004, through the date of transfer of the State's holdings (since application of that law and the collective agreement regarding the wage cut expired on June 30, 2005, the period will be from August 28, 2004 to June 30, 2005). The value of the bonus for the period to September 30, 2005, is NIS 14 million. No provision in respect of such a bonus was recorded in the financial statements, since the conditions for its grant were fulfilled only in the fourth quarter. The grant was paid in October 2005.

- E. (1) During the period of report, Bezeq Gold Holdings Ltd. (hereinafter – Bezeq Gold) a wholly-owned subsidiary of the Company, sold NIS 400 million par value of debentures (Series 4), which it had purchased from the Company. The proceeds in respect of the sale, in the amount of NIS 428,910 thousand, was transferred to the Company by Bezeq Gold as repayment of a loan which the Company extended to Bezeq Gold for purchase of those debentures (Series 4). Subsequent to the sale of the debentures, Bezeq Gold no longer holds any debentures (Series 4) of the Company, and all the debentures from this series, a total of NIS 1,200,000,000 par value, are held by the public.

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

- (3) On August 17, 2005, Bezeq Gold sold NIS 100 million of debentures (Series 5) of the Company. The proceeds from the sale, NIS 110,950 thousand, was transferred as (partial) repayment of the loan provided by the Company to Bezeq Gold for purchase of the debentures (Series 5).

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL (CONTD.)

E. (contd.)

(4) On February 27, 2005, Pelephone issued NIS 500 million debentures bearing 4.4% interest, by way of a private placement to institutional investors. The debentures are repayable in twenty half-yearly payments of the principal and interest. On June 29, 2005, Pelephone issued NIS 333 million debentures in a private placement to institutional investors, for a consideration of their par value. The proceeds of the issuance were received on July 3, 2005. The debentures are linked to the Index, bear annual interest of 4.55% and commencing January 2006 will be repaid in twenty half-yearly payments of principal and interest. The purpose of raising this debt is to diversify Pelephone's sources of credit, repayment of loans and extension of the period of the debt.

F. On May 10, 2005, the Company received notice from the Director General of the Government Companies Authority dated May 9, 2005, pursuant to Section 37 of the Securities Law, 5728-1968, that representatives of the State had decided to select Ap.Sb.Ar. Holdings Ltd. ("Ap.Sb.Ar.") as Preferred Bidder in the off-exchange process for the sale of 781,513,683 shares of the Company held by the State (which account for approximately 30% of the Company's shares), as well as an option to purchase 277,697,862 Company shares held by the State (which account for approximately 10.66% of the Company's shares), in accordance with the terms of the Sale Agreement ("the State's Holdings").

On October 11, 2005, transfer of the State's Holdings to Ap.Sb.Ar. was completed for a consideration of approximately NIS 4.246 million. The shares of the Preferred Bidder in the Company are held in trust by Romema Investment Co. Ltd.

As a result of closing the transaction and approval of Ap.Sb.Ar. to assume control of the Company in accordance with the Communications Law, the Company was released from certain restrictions which were imposed upon it as a company controlled by the State of Israel, including the cancellation and/or modification of some of the provisions of its Articles of Association, which are similar to certain provisions in the Government Companies Law, 5735-1975. In addition, lenders, the balance of whose loans amount to approximately NIS 370 million, may demand immediate repayment of the debentures they hold. The debentures were classified in the Company's balance sheet as short-term liabilities.

The Company was informed that under the agreement between the State and Ap.Sb.Ar., Ap.Sb.Ar. may request that the State vote together with it (within the limitations set out in the agreement concerning certain matters), in respect of 10.66% of the Company's shares held by the State and for which Ap.Sb.Ar. received a purchase option and in respect of 1.01% of the Company's shares which will remain in the State's hands during the period commencing October 11, 2005 (the closing date of the transaction) and ending at the end of the period for exercise of the option, and in respect of 4.71% of the Company's shares held by the State and designated for allotment to Company employees – for the same period or until transfer of ownership of these shares to the Company employees, whichever is the earlier.

G. Further to Note 1F to the financial statements as at December 31, 2004, and completion of the sale of the controlling interest in the Company in October 2005, Company employees are entitled to a compensation in the form of an allotment of 4.71% of the shares of the Company which are held by the State. The allotment of the shares will be implemented by means of a stock options plan, according to an outline published by the Company on November 15, 2005, as follows:

(1) The offered securities

- a. Up to 122,697,648 options, registered by name, each of which can be exercised for one common share of par value of NIS 1 of the Company (subject to adjustments).
- b. The options will not be listed for trading on the stock exchange. The common shares (registered by name) of par value of NIS 1 each, designated for allotment against exercise of the options, are listed for trading on the stock exchange.

Notes to the Financial Statements as at September 30, 2005

NOTE 1 – GENERAL (CONTD.)

G. (contd.)

(2) Consideration for the securities and exercise price

- a. The options are offered to eligible employees, including a group of former employees ("Offerees") free of charge.
- b. The exercise price of each of the options will be NIS 4.037 ("the Exercise Price"). It is noted that the Exercise Price reflects an aggregate price of 20% of the Company share price in an offering to the public according to the prospectus (NIS 5.0239 adjusted to the Index of September 2005) and 80% of the average price of the share on the stock exchange in the 30 days' trading prior to the closing date (NIS 5.9531), less a discount of 30%. The Exercise Price will be linked to the Consumer Price Index (with no added interest), and with adjustments for the distribution of dividends by the Company and for offerings of bonus shares and the benefit component in a rights offering..

(3) Exercising the options

Commencing January 1, 2008, each of the Offerees shall be entitled to exercise one third of the options offered to him ("the First Portion"), and shall be entitled to submit a Notice of Exercise as defined below – subject to the provisions of Section 102 – at any time from that date until the end of four years and 20 business days from the Determining Date.

At the end of the third year from the Determining Date, the Offeree will be entitled to exercise an additional third of the total quantity of his options ("the Second Portion"). The Offeree will be entitled to submit Notice of Exercise as defined below, for the options comprising the Second Portion – subject to the provisions of Section 102 – at any time commencing from the end of three years from the Determining Date until the end of four years and twenty business days from the Determining Date.

At the end of four years from the Determining Date the Offeree will be entitled to exercise an additional third of the total quantity of his options ("the Third Portion"). The Offeree will be entitled to submit Notice of Exercise as defined below, for the options comprising the Third Portion – subject to the provisions of Section 102 – no later than the end of four years and twenty business days from the Determining Date.

If the Offeree does not exercise options as is his right in a certain portion, those options will be added to the next portion.

The estimated fair value of each share option is computed according to the share price on September 30, 2005, which was NIS 1.49. This estimate was calculated by applying the Black-Scholes-Merton formula to the pricing of the options less a 25% discount for the absence of tradability. The formula includes a standard deviation of 27% based on the historical volatility of the shares, and risk-free interest rate of 2.9%. The total value of the benefit in the plan is approximately NIS 183 million.

Standard 24 of the IASB – Share-Based Payment is scheduled to come into force on January 1, 2006. The Company intends to complete the allotment of the options before that date, and therefore this standard, including its transition provisions, will not apply to the allotment. Accordingly, the financial statements do not include expenses in respect of the benefit component included in the allotment. The tax benefit to which the Company is entitled will be credited to a capital reserve at the date of recognition of the expense.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. GENERAL

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

Notes to the Financial Statements as at September 30, 2005

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

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS

Accounting Standard No. 19 – Taxes on Income.

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

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

1. In August 2005 the IASB published Accounting Standard No. 22 – Financial Instruments: Disclosure and Presentation. The standard sets out the rules for the presentation of financial instruments in financial statements and details the proper disclosure in respect thereof. In addition, the standard determines the method of classification of financial instruments as liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which assets and liabilities should be set off. The new standard will apply to the financial statements for the periods commencing January 1, 2006 or thereafter. The standard determines that it should be adopted "from now on". The comparative amounts stated in the financial statements for periods commencing on the date of application of the standard will not be restated. In the opinion of Company Management, the application of this standard is not expected to have a material effect on the results of operations and the financial position of the Company.
2. In September 2005 the IASB published Accounting Standard No. 24 – Share-Based Payment. The standard requires recognition of share-based payment transactions in financial statements, including transactions with employees or other parties which are to be made in capital instruments, cash or other assets. According to the standard, share-based payment transactions in which goods or services are received will be recorded at their fair value. In addition, the standard determines various disclosure requirements relating to the nature and extent of share-based payment arrangements which existed during the period, and disclosure relating to how the fair value of such arrangements was determined. The standard will apply to financial statements for the periods commencing January 1, 2006. Earlier implementation is recommended. The provisions of the standard should be applied to every share-based payment transaction made subsequent to March 15, 2005, and which had not yet vested by the date of implementation of the standard. In addition, comparative information relating to the periods from March 15, 2005 should be restated. Concerning an issuance of shares to employees by means of a stock options plan following sale of the controlling interest in the Company, see Note 1G.

Notes to the Financial Statements as at September 30, 2005

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

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

	<u>Consumer price index</u>	<u>Exchange rate of the US dollar</u>	<u>Exchange rate of the euro</u>
	%	%	%
For the nine-month period ended:			
September 30, 2005	1.889	6.732	(5.944)
September 30, 2004	1.207	2.352	(0.152)
For the three-month period ended:			
September 30, 2005	1.385	0.525	0.009
September 30, 2004	(0.198)	(0.334)	1.079
For the year ended December 31, 2004	1.207	(1.621)	6.212

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES**A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS")**

In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. DBS has accumulated considerable losses and negative cash flows. The loss for the year 2004 amounted to approximately NIS 366 million and the loss for the nine-month period ended September 30, 2005, amounts to approximately NIS 244 million. As a result of these losses, the capital deficit and working capital deficit as at September 30, 2005 amount to approximately NIS 3,469 million and NIS 476 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,562 million (nominal). The Company's equity in the accumulated losses of DBS from the date of investment is approximately NIS 1,496 million, of which approximately NIS 226 million was recorded during the period of account. (DBS's loss for the period, net of new loans provided by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 63 million.

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

- a. The total amount of the additional injection will be limited to a maximum of NIS 350 million (instead of NIS 440 million).
- b. Regarding the NIS 195 million of the additional funding already transferred by the Company to DBS, the Minister does not intend to take any further action.
- c. The remainder of the amount, a maximum of NIS 155 million, will be transferred in equal portions, once every quarter, during 2005, based on the following principles:
 - (1) The Company's share in the aforementioned amount will not exceed 55% (i.e. a maximum of NIS 85.25 million).
 - (2) The share of the other shareholders in DBS and of the banks or institutional bodies in the transfer of the balance will be not less than 45% (i.e. a minimum of NIS 69.75 million).

Notes to the Financial Statements as at September 30, 2005

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

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

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

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

- a. The Company will be able to inject up to 75% of the maximum amount (NIS 64 million) by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it had transferred by the date of the letter), provided that by the end of June 2005, the proportions of the transfer decided upon by the former Minister are fully maintained.
- b. The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) during the period from July 1, 2005, through the end of 2005, provided that the proportions of the transfer are maintained as set out in the former Minister's letter.

In the opinion of the DBS and the Company, implementation of the instructions in the Minister's letter could be materially harmful to DBS, and to the Company as the principal shareholder in DBS.

On January 6, 2005, the Company's Board of Directors resolved, that in view of the onerous conditions on which the merger of the Company and DBS was made contingent by the Antitrust Commissioner ("the Commissioner") (increasing the Company's holdings in DBS to more than 50%), (in which, *inter alia*, the Commissioner restricted the funds that could be injected by the Company into DBS so that for a period of nine months from the date of approval of the merger, they would not exceed the proportional part of the Company in the shares of DBS while the other part would be injected by other shareholders in DBS and by institutional investors), to delay, at that time, the exercise of the warrants for shares it received from DBS in accordance with agreements signed between shareholders in DBS and DBS, so that its holdings in DBS would remain at that time at approximately 49.8%. The Company and DBS each filed an appeal against the decision of the Commissioner to make the Company's permission to increase its holdings in DBS conditional. Subsequently, the Company applied to strike the appeal it had filed, *inter alia*, because the validity of the condition that limited injections of funds by the Company into DBS was about to expire. DBS also filed an application to strike the appeal it had filed, for the same reasons, and on September 19, 2005, the appeals were stricken. The cable companies have also filed an appeal against approval of the merger, and this appeal is pending, after applications of the Company and DBS to strike the appeal *in limine* were dismissed on July 25, 2005, and is scheduled for a preliminary hearing on December 1, 2005.

Notes to the Financial Statements as at September 30, 2005

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

On February 17, 2005, the Board of Directors of the Company resolved that it affirms its resolution from March 2004 as amended in May 2004, to continue to invest the Additional Injection in DBS according to the approved work plan, together with the other shareholders and financial bodies. This resolution was based, *inter alia*, on an external legal opinion that the Minister of Communications does not have the authority to forbid injections of funds into DBS. On February 23, 2005, the Minister of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications will be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including considering calling in the bank guarantee deposited by the Company as required by its general license. The Company applied to the District Court in Jerusalem for a declaratory order determining that the decisions of the Ministers of Communications which limited the Company's transfers of funds to DBS, were given *ultra vires* and are therefore void. On March 20, 2005, the District Court ruled that the competent court which may make a decision on the matter is the High Court of Justice, and accordingly transferred the proceeding to that court. Accordingly, on April 17, 2005, the Company filed both an application for leave to appeal the decision of the District Court and an application to convert the claim in the Supreme Court – if the application for leave to appeal is dismissed – to a petition to the High Court of Justice. The application for leave to appeal the decision of the District Court was dismissed, and on May 10, 2005, the petition was filed in the High Court of Justice on this matter. It should be noted that DBS also filed a similar petition in the High Court of Justice on the same matter, to which the cable companies were joined as respondents. On October 11, 2005, a hearing regarding the petitions of DBS and the Company was held in the High Court of Justice, against the authority of the Minister of Communications to intervene in injections of funds to DBS by its shareholders, including the Company and external entities. The petition raises basic questions which are far from simple, both factually and legally, which were brought into sharp focus in the hearing. The High Court of Justice has not yet handed down its decision, and the Company, relying on its legal advisers, is unable to estimate the outcome. It should be noted that concurrently with the proceeding, the Ministry of Communications announced its intention to foreclose on the Company's guarantee of NIS 10 million. On July 7, 2005, the Company, as is its right under the general license, filed an appeal against the decision of the Ministry to foreclose the guarantee. See also Note 6A(25).

The terms of the long-term loans which DBS received from certain banking corporations (hereinafter "the Banks"), whose balance as at September 30, 2005, amounts to NIS 1,289 million (including current maturities), impose various restrictions (such as restrictions regarding a lien on or sale of certain assets, a restriction on receipt of credit from other banking institutions without prior approval, a restriction relating to the repayment of shareholders' loans and a demand to comply with financial criteria – hereinafter "the Conditions"). As at September 30, 2005, DBS is in compliance with those Conditions.

In March and April 2005, DBS signed agreements with three institutional bodies, whereby they would extend loans to DBS in a total amount of NIS 50 million (two institutional bodies would provide NIS 15 million each and the third would provide NIS 20 million). As at the balance sheet date, DBS had received all these amounts.

The above loans are linked to the Index and bear interest at 11%.

The loans, together with the interest and linkage differentials, are due on December 31, 2013, but can be repaid earlier subject to repayment of part of the loans to the Banks, on terms laid down in the agreement.

The three institutional bodies had an option to extend additional loans, in the same amounts as above, provided that the amounts of the loans are required according to DBS's business plan. In June 2005 one of the institutional bodies exercised the option and transferred to DBS an additional NIS 20 million. In September and October 2005 the other two institutional bodies exercised the option and transferred to DBS NIS 15 million in September and NIS 15 million in October 2005.

Notes to the Financial Statements as at September 30, 2005

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

It should be noted that the Company's undertaking under the signed loan agreements applies also to these additional amounts. The additional loans (as well as the other loans extended to DBS by institutional entities as described above), are not in compliance with some of the Conditions and restrictions imposed by the Ministers of Communications as described above, in respect of which the Company and DBS applied to the courts.

As described in Note 6B below, the Company undertook, in connection with the abovementioned three loans, that if by December 31, 2013, the loans are not repaid (in full or in part), or upon the existence of certain other conditions, the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differences) and an amount computed according to a predetermined formula which takes into account the value of DBS at that time.

As at September 30, 2005, the Company had transferred approximately NIS 284 million of the Additional Injection.

At a meeting of the shareholders of DBS on January 16, 2005, the representatives of two other shareholders announced that they intend to recommend to the appropriate bodies of their companies that they participate in further transfers of NIS 20 million and NIS 10 million, respectively, to DBS. These recommendations for additional transfers will be in a situation where DBS will also have funding from the other shareholders (including the Company) for executing its business plan and without it instituting a legal proceeding requesting interim relief that could halt the process. From the date of that decision to the date of approval of these financial statements, the additional shareholders have transferred NIS 17 million to DBS, of which NIS 12 million relate to the aforementioned notice.

The continued operation of DBS is conditional upon arranging for the financial resources it needs in the coming year.

In the opinion of the Management of DBS and of the Company, based, *inter alia*, on the 2006 work plan, there is a good chance that the financial resources that DBS will required in the coming year, including topping up the amounts required according to the work plan, can be arranged.

B. PELEPHONE COMMUNICATIONS LTD.

Further to Note 8D(2) concerning an appeal filed in the Antitrust Court by Cellcom, in which it petitions for cancellation of the approval of the merger between Pelephone Holdings and Pelephone. On August 10, 2005, Cellcom requested that the appeal be struck, and on August 15, 2005, the court instructed that the appeal be stricken.

C. XPERT INTEGRATED SYSTEMS LTD. ("Xpert")

On July 11, 2005, the Company sold all its holdings (16.3%) in Xpert. The Company's share of the proceeds from the sale of Xpert amount to approximately \$ 2.8 million, which will be paid in installments, that last of which is due in January 2007. A provision for the impairment in value of the investment in the amount of approximately NIS 6 million has been made in the financial statements, based on the above selling price.

D. B-ONE GENERAL PARTNERSHIP

At the end of the third quarter it was decided to dissolve the B-ONE partnership. Commencing the fourth quarter Pelephone took upon itself the obligations provided by the partnership.

Notes to the Financial Statements as at September 30, 2005

NOTE 5 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

EARLY RETIREMENT PLAN

- A. Further to Note 16D to the 2004 financial statements of the Company concerning the process for selecting an alternative to the Makefet Fund in coordination with the employees' representatives, on April 17, 2005, a special collective agreement was signed between the Company and the employees' representatives and the Histadrut, enabling early retirement of employees through that alternative entity. On June 28, 2005, a contract was completed and signed between the Company and Harel Insurance Co. Ltd. ("Harel"). The commitment regulates pension payments in respect of early retirement, as well as retirement pension payment differentials deriving from legislative amendments to the Israeli Economy Recovery Plan Law (Legislative amendments for attaining budget targets and economic policy for 2003 and 2004 fiscal years), 5763-2003) for employees who retired commencing at the end of 2003 and beginning of 2004, and/or who will retire from the Company in accordance with the special collective agreement for retirement dated September 2000, as amended on March 18, 2004 ("the Retirement Agreement"). Following execution of the agreement with Harel, the special collective agreement between the Company and the employees' representatives and the Histadrut was updated and amended on the same date (June 28, 2005).

It should be noted that all the approvals required for validating the agreement with Harel and the special collective agreement dated April 17, 2005, and its amendment, which was signed between the Company and the employees' representatives and the Histadrut, regulating the early retirement of employees through Harel, as the substitute for the Makefet Fund, have been obtained.

As a result of the agreement described above, subsequent to making adjustments which also derived from an updated estimate of total liabilities for employees' retirement, the Company reduced the provision for early retirement in the financial statements for the period ended June 30, 2005 by approximately NIS 90 million.

- B. Notice of a labor dispute sent by the employees' representatives on April 5, 2005, was canceled on April 13, 2005, after an exchange of letters between the Company, the employees union and the Government Companies Authority, the main points of which were:
- (1) "It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the employees' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which states that 'Immediately after signing this agreement, the parties will commence intensive negotiations to regulate the retirement of the remaining transferred employees by 2011 on the one hand, and the requirements of the Company's Management for organizational and other changes on the other hand.
 - (2) The Government Companies Authority clarified that if after sale of the State's holdings in the Company an agreement as referred to above is made, no additional approvals for extension of the validity of the retirement agreement will be required from the Government Companies Authority and the Supervisor of Wages at the Ministry of Finance. The Government Companies Authority also clarified that to the extent its approval is required for the agreement, the sale of the State's holdings will replace the approval.
 - (3) The correspondence will be presented to the participants in the proceeding for the sale of the State's holdings in the Company."

In the opinion of the Company, at this stage, the above will not change the existing agreement. Furthermore, the aforementioned clarifications do not have an effect on the financial statements of the Company.

Notes to the Financial Statements as at September 30, 2005

NOTE 5 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

EARLY RETIREMENT PLAN (CONTD.)

- C. It is noted that even before completion of transfer of the State's holdings in the Company to Ap.Sb.Ar, a document of principles was signed between Ap.Sb.Ar. and the workers union, for the signing of a future agreement between the Company and the workers union, which was forwarded to the Company close to the date of publication of these financial statements, which includes reference to a change in the organizational structure of the Company which involves the retirement and/or laying off of employees; capital reduction while maintaining the financial strength of the Company, and employee compensation. As at the date of publication of these financial statements, negotiations have not yet commenced.

NOTE 6 – CONTINGENT LIABILITIES

A. CLAIMS AND CONTINGENT LIABILITIES

The Company and the investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 19A to the financial statements of the Company as at December 31, 2004. No material changes in contingent liabilities have occurred up to the date of signing these financial statements, other than the following:

- (1) Further to Note 19A(1) to the financial statements as at December 31, 2004, concerning a petition filed in the High Court of Justice by 128 senior employees who were/are employed under personal employment agreements, to set aside a decision of the National Labor Court which dismissed a claim for a 33% salary increment (corresponding to the salary increment given to members of the Knesset and senior civil servants), on May 2, 2005, the High Court of Justice dismissed the petition.
- (2) Further to Note 19A(2)a. to the financial statements as at December 31, 2004, concerning the investigation of the Antitrust Commissioner into suspected restrictive arrangements relating to the supply of large exchanges (area of public switching) and following the dismissal of the Company's petition to direct the Antitrust Authority to allow the Company a hearing, to submit classified material and to refrain from issuing a determination according to Section 43 of the Antitrust Law, discussions were held between the Company and the Antitrust Authority in an attempt to arrive at an agreed Order (which would prevent issue of the determination). These discussions were fruitful, and the Company and the Authority reached agreement regarding the wording of an order that would be filed in the Antitrust Court for its approval. The text of the agreed order includes an undertaking by the Company to pay the State Treasury the sum of approximately NIS 2 million, without admitting violation of the Restrictive Trade Practices Law, and confirmation of the Authority that it will refrain from instituting any proceedings against the Company in connection with the public switching affair. The Company, relying on its legal advisers, believes that an application for approval of this agreed order will be filed by the Authority, with the consent of the Company, in the near future. Taking into consideration that the Antitrust Court approved a similar application which was filed in this affair by Telrad and Tadiran it is probable that this application will also be allowed.
- (3) Further to Note 19A(3) to the financial statements as at December 31, 2004, concerning the claim of a group of employees who were employed as non-permanent employees at the Ministry of Communications. On March 6, 2005, a partial judgment was handed down in which the allegation of the plaintiffs concerning their status as "transferred employees" was dismissed, and the court stated its position that the partial decision should become final. The plaintiffs' lawyer was supposed to give notice of the position of the claimants on the matter. On August 11, 2005, after no notice was received on behalf of the plaintiffs, a decision was given stating that the partial decision is a final decision, thereby dismissing the claim.

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (4) a. Further to Note 19A(5) to the financial statements as at December 31, 2004, concerning a number of claims in the matter of recognition of various salary components as pension components and recognition of various components of the determining salary for computing severance pay – the maximum exposure in respect of these claims could, under certain assumptions, reach approximately NIS 2.6 billion. However, in the light of the two judgments on the matter of the administrative call duty component and the matter of the grossing up of the tax component, as described in the aforementioned note, the Company re-assessed the situation and, relying on its external legal advisers, concluded that the exposure amounting to approximately NIS 2.2 billion (out of the maximum exposure) is remote. Out of the remainder of the exposure in the amount of approximately NIS 392 million and in respect of claims concerning components which the Company believes, relying on its external legal advisers, that the risk cannot be assessed or that the Company's chances of success in these claims are good, the Company did not include a provision in the financial statements other than a provision of NIS 50 million in respect of the administrative call duty component (according to a formula determined in the decision on this matter) and in respect of a possible settlement in the claim referred to in Note 19A(5)c. to the 2004 financial statements of the Company.
- b. Further to Note 19A(5)a to the financial statements as at December 31, 2004, concerning the claim of 2,423 Company retirees who were transferred from the Ministry of Communications to the Company upon its establishment, on September 6, 2005, the National Court allowed the appeal of the plaintiffs to strike the claim *in limine*. The Court determined that since the appellants petitioned for a declaratory decision that examines eligibility to include various components in the pension-determining salary, a declaratory decision proceeding in this case is correct, since the application is to lay down principles. Accordingly, the National Court set aside the decision of the Regional Court and cancelled the order to strike the claim *in limine*.
- (5) Further to Note 19A(6) to the financial statements as at December 31, 2004, concerning an action together with an application for its approval as a class action by virtue of Article 29 of the Civil Procedures regulations, 5744-1984 ("Article 29"), alleging that the Company unlawfully collected from its subscribers "collection expenses" in respect of Company bills which were not paid on the payment date noted on them, and did so before the Company commenced any collection actions in connection with the plaintiff's debt. On September 1, 2005, the decision was given in the additional hearing in the E.Sh.T. Ruling ("the Additional Hearing:"), stating that class actions cannot be filed pursuant to Article 29. On September 14, 2005, the Supreme Court requested the position of the parties as to the continuation of the proceedings in an application for leave to appeal, in light of the decision in the Additional Hearing. The Company filed its position in the Court, in which it stated that in view of the decision in the Additional Hearing, the application for leave to appeal should be allowed. The plaintiff's position was that the hearing of the application should be delayed until the completion of the legislation of a class action law. The Company, relying on its legal advisers, is unable to assess whether and how proposed class action legislation will influence the proceedings in this case.
- (6) Further to Note 19A(8) concerning an action and application for its approval as a class action, against the Company, Bezeq International and the other international communications operators, alleging that the Company unlawfully collected VAT on some international telephone calls originating outside Israel – after the decision was handed down in the E.Sh.T. case on September 1, 2005, (see Note 6 A(5)) above, the appellants stated their position that they should be permitted to stay the proceedings until the promulgation of a new law concerning class actions or alternatively, they should be allowed to amend their claim. The Company gave notice of its objection to a stay of proceedings in view of the decision in the E.Sh.T. case, and that in any case, since the Company is a formal defendant in the case, it should be stricken from the proceeding. Therefore, the Company did not include a provision relating to this matter in its financial statements. Bezeq International filed its response in the court, stating that according to the decision of the District Court in this case and the decision in the E.Sh.T. case, there was no choice but to dismiss the appeal. The legal advisers of Bezeq International estimate, based on the aforementioned, that Bezeq International has become

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

indifferent to the outcome of the hearing and accordingly, Bezeq International has also decided not to include a provision relating to this matter in its financial statements.

- (7) Further to Note 19A(9) to the financial statements as at December 31, 2004, concerning dismissal of an application for approval of a claim as a class action against the Company and Pelephone, in which it was alleged that the maximum payment that could be collected from a Company subscriber calling a Pelephone subscriber was lower than the amount actually collected – no appeal was filed against the decision and therefore the proceeding has ended.
- (8) Further to Note 19A(10) to the financial statements as at December 31, 2004, concerning two claims for damages in respect of bodily harm which were filed against the Company in 2003 and 2004 in connection with the operation of the Hillel broadcasting station:
- a. On May 9, 2005, the Company received a claim for damages amounting to NIS 46 million which was filed by 14 plaintiffs who were and/or are residents of the moshavim Porath, Ein Vered, Ein Sarid and of the settlement of Kadima, against the Company, the Broadcasting Authority and the State of Israel. According to the plaintiffs, the negligence and/or omissions of the defendants in operating the Hillel broadcasting station, which is situated near the above locations, and which for many decades has allowed uncontrolled and hazardous exposure to radiation from the Hillel broadcasting stations and from installations connected with it, have caused them (or their heirs) bodily harm and property damage of various kinds. It is noted, as described in the above Note, that the opinions of experts in occupational medicine and in non-ionizing radiation safety, filed by the Company as part of its defense in the two claims, state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the cancer allegedly suffered by the plaintiffs in the claims. In relation to these claims, the Company, relying on its external legal advisers (whose opinion relied on the aforementioned expert opinions), believes that the chances of the claims being dismissed are greater than the chances of their being allowed. Accordingly, no provision has been made in the financial statements in respect of this claim.
- b. On May 23, 2005, the Company received a claim for damages in respect of property and financial damages amounting to approximately NIS 141 million, which were allegedly sustained by 53 plaintiffs who were and/or are residents of Moshav Porath. The claim was filed against the Company, the Broadcasting Authority and the State of Israel in the Tel Aviv District Court. According to the plaintiffs, the negligence and/or omissions of the defendants in operating the Hillel broadcasting station, which is situated near the moshav, were the direct cause of irreversible damage to agricultural fields owned by moshav residents, harm to the livelihood of the moshav and enormous financial damages, due, *inter alia*, to the effects of operation of the Hillel broadcasting station and the electromagnetic fields radiating from it towards the agricultural land of the plaintiffs, which the plaintiffs allege damaged their crops and prevented them from making proper use of their agricultural land. In addition, an application was filed to separate the reliefs so as to enable future claims for damages. On September 1, 2005, the plaintiffs filed an application to amend the statement of claim, in which they wished to delete 23 plaintiffs and to reduce the amount claimed by the remaining 30 plaintiffs, so that the amount of compensation sued for in the statement of claim would be approximately NIS 35 million. Furthermore, at this stage a partial fee has been paid to the Court and six of the plaintiffs have filed an amended application for full or partial exemption from payment of the fee. The court has not yet given its decision on these applications. The statement of defense on behalf of the Company and the other defendants has not yet been filed. At this early stage, the Company, and accordingly, no provision has been made in its financial statements in respect of this claim.

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

As in the first two claims, in this claim the Company has arguments of defense against the other defendants – the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the Company operated the station for and on behalf of the other defendants, in accordance with the operational directives and requirements of the other defendants or either of them, and that the Company acted in accordance with those various directives and requirements, including those which were responsible for the operating activities that were carried out from the Hillel broadcasting station. In addition, also regarding the above claims, the Company has arguments against the relevant insurers, where clarification with the insurance companies of the matter of the insurance cover for the events which are the subject of the claims, have not yet been completed.

It is noted that on December 31, 2003, the Company ceased all broadcasts from the station, as required by the State and the Broadcasting Authority, and since then the site has ceased to function as a broadcasting site.

- (9) Further to Note 19A(14) to the financial statements as at December 31, 2004, concerning a claim together with an application for recognition as a class action, alleging unlawful collection of interest on arrears in respect of a debt which the Company collects for other communications providers, on June 6, 2005, a decision was handed down by the Tel Aviv District Court, dismissing the plaintiffs' claim and their application for approval as a class action, and ordering them to pay costs. On September 18, 2005, the plaintiffs filed an appeal against the decision in the Supreme Court. No date has been set for hearing the appeal. The Company, based on the opinion of its legal advisers, is unable to assess the prospects of the appeal, and therefore no provision is included in the financial statements in respect of this claim.
- (10) Further to Note 19A(19) to the financial statements as at December 31, 2004, concerning a claim filed against the Company and against Makefet Fund by 265 retirees of the Company, for enforcement of the agreement from April 2001, whereby the employees should be allowed to switch the track of their choice from B to A, on June 6, 2005, the court decided not to dismiss the claim *in limine* and not to strike the retirees' organization as a plaintiff, but it instructed that the items in the claim relating to demands for payment be struck from the claim (provided a fee has not been quantified and paid in respect of them), so that in practical terms, the claim remains declaratory only. An application was filed in the court which is similar to two earlier applications which were filed to add another group of employees to this claim. The application is to add 34 more employees. If this application is allowed, the total number of plaintiffs will be 299. The case is scheduled for hearing on December 15, 2005.
- (11) Further to Note 19A(21) to the financial statements as at December 31, 2004, concerning various claims of six employees who retired on disability pensions due to their medical condition and against a background of the pension reform, the employees were summoned for a repeat medical examination and initially they were offered a 50% reduction in their pension. The employees filed an appeal against Makefet and/or the Company in a claim for payment of a full disability pension. On June 20, 2005, the Supervision of Insurance Business Law was amended so that a retiree whose disability was determined before October 2003 and who accumulated at least five years of disability, or who reached retirement age before the decision to reduce his disability percentage, would not have his pension reduced. Following this amendment, there remained claims of four retirees who meet these criteria. The proceeding in two of the claims to which the amendment to the law does not apply, will continue.

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (12) Further to Note 19A(22) to the financial statements as at December 31, 2004, concerning a claim and application for recognition as a class action, in which it is alleged that the Company adds Value Added Tax to the interest on arrears that it collects in respect of late payment, thereby over-collecting in contravention of the law, since the VAT component is embodied in the Accountant General's arrearage interest that the Company is entitled to charge. On May 3, 2005, a decision was given whereby the Attorney General is required to provide his position on the question of whether he intends to intervene in the proceedings relating to the claim and to clarify his position on whether arrearage interest of the Accountant General includes the VAT component or not. On September 15, 2005, the position of the Attorney General was filed, according to which the law is that the Accountant General's arrearage interest does not include a VAT component. The court instructed the plaintiffs to file their position in response to the position of the Attorney General, and to state whether they intend to continue their claim.
- (13) Further to Note 19A(23) to the financial statements as at December 31, 2004, concerning a class action in which it is alleged that the Company's charges and calculations for Internet access in the "WOW Extra" and "WOW Summer 2004" campaigns constituted deception, fraud, unjust enrichment and overcharging, the Company's investigation revealed that the plaintiff was not overcharged and for technical-recording reasons the charge was split into a charge and a credit. Following the Company's response, the plaintiff requested that his claim be struck from the record, and subsequently, on June 8, 2005, with the consent of the parties, the Haifa District Court decided to strike the claim.
- (14) In the matter of the dispute between the Company and the Ministry of Communications regarding payment of royalties in respect of interconnect revenues from cellular subscribers and Company subscribers in the period between April 1999 and the end of 2000, on July 25, 2005, the Company received a letter from the Director General of the Ministry of Communications demanding that the Company pay the above disputed royalties debt in the amount of approximately NIS 17 million. The Company replied to the Ministry of Communications that it is maintaining its legal position, namely, that in respect of the relevant period the Company was not required to pay royalties to the State for interconnection of calls from cellular subscribers to Company subscribers, and that the Ministry gave no reasons for its decision and did not relate to the contentions and data presented recently by the Company to professional personnel at the Ministry. The Company also requested an urgent meeting to discuss the matter with the Director General of the Ministry of Communications, and to postpone the demand for payment until after the aforementioned discussion. The legal advisers of the Company are unable, at this stage, to estimate the outcome of the dispute. However, in the opinion of the Company, that outcome is not expected to have a material impact on the results of the Company's operations or on its financial position.
- (15) On August 15, 2005, the Company received a claim and application for its approval as a class action under the Restraint of Trade Law, 5748-1988 and the Consumer Protection Law, 5741-1981 concerning the Company's method of billing for calls made using the Company's phone card – Bezeqcard.

The plaintiff alleges that the pulse on which the Company bases the cost of calls made with a Bezeqcard is based on a whole minute rather than seconds, as prescribed in the law. The amount of the class action is estimated by the plaintiff at approximately NIS 38 million (a claim in respect of the past seven years, based on the plaintiff's allegation of advertisements about the number of Bezeqcard-holders, the number of minutes of the call made using a Bezeqcard and the plaintiff's own calculations). The Company and its legal advisers are studying the claim and the application, and are unable to estimate the chances of the outcome of the claim at this stage. Accordingly, no provision has been included in the financial statements in respect of this claim.

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (16) Further to Note 19A(26) to the financial statements as at December 31, 2004, concerning a claim filed against Bezeq International by a systems vendor, a preliminary hearing was held on March 15, 2005, in which a proposal was made to transfer the case to an arbitration proceeding. The case was scheduled for memorandum, which was postponed in view of the ongoing contacts between the parties. The legal advisers of Bezeq International are unable to estimate the chances of the outcome of the claim at this stage, and accordingly, Bezeq International has decided not to include a provision in its financial statements in respect of the claim.
- (17) Further to Note 19A(27) to the financial statements as at December 31, 2004, concerning a claim filed in the Tel Aviv District Court against Pelephone by the State of Israel in respect of royalties allegedly payable to it for the period from January 1994 to February 1996, the mediation proceeding which began in 2002 yielded no results other than the parties' agreement to amend the amount of the claim, as described in the above Note. The Court has not yet given its decision approving the adjustment. In the opinion of Pelephone's Management, which relies on the opinion of its external legal advisers who are handling the claim, Pelephone has a substantial defense. A provision has been included in Pelephone's financial statements which has been assessed by its Management to be appropriate should Pelephone be required to pay any amount in the framework of the claim.
- (18) Further to Note 19A(28) to the financial statements as at December 31, 2004, concerning allegations of the plaintiffs that Pelephone's pre-paid service constitutes infringement of a patent of the suing company, a decision was recently given by the Registrar of Patents on the matter of revocation of the patent, stating that the patent is unworthy of registration. The date for filing an appeal against the decision of the Registrar of Patents has lapsed.
- (19) On July 26, 2005, a petition was filed in the High Court of Justice against the Government of Israel, Pelephone and others, protesting the Government decision on July 24, 2005, to appoint an inter-ministry committee of directors general to examine the subject of cellular antennae in Israel and to submit recommendations to the Government on the matter within one month. The petition is to grant a conditional order against the Government of Israel requiring it to provide reasons why the aforementioned decision should not be cancelled and why an immediate meeting should not be held, without delay, to discuss the proposal of the National Council for Planning and Construction for Amendment No. 1 to Urban Outline Plan 36A. On July 26, 2005, the court forwarded the petition for the response of the respondents within 15 days. The responses have not yet been filed and the hearing of the petition has not yet been scheduled.
- (20) 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 of the Environment), the cellular companies, including Pelephone, and a company named Elidov – Building & Investments Co. 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 in 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 favor of a third party" in their favor and in favor 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.

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

The plaintiffs are petitioning for a long list of reliefs (approximately 20 in number), all declaratory, the main ones being to declare that the cellular companies and the other defendants must pay the compensation ruled against the local councils in claims under the aforementioned Section 197.

The date for filing a statement of defense was extended by consent until November 10, 2005.

At this stage, Pelephone, relying on its legal advisers, is unable to assess the chances of the outcome and implications of the claim.

- (21) In October 2005 a notice was received at the offices of Pelephone regarding the filing of an application to add Pelephone to an appeal proceeding filed by the owners of rights in land adjoining a cellular communications site operated by Pelephone and others in Ramat Gan. The appeal was filed against a decision of the local committee in Ramat Gan to reject a claim submitted to it in respect of impairment of value by virtue of Section 197 of the Planning and Construction Law, by the owners of those rights. The amount of the claim is approximately NIS 100 million. The notice also stated that the local committee was making the application since it believes that Pelephone is liable for any damage caused as a result of the claim/appeal being allowed. A decision on the addition of Pelephone to the proceeding has not yet been made.

The proceeding is being studied by Pelephone, which intends to oppose it in its entirety. In Pelephone's opinion, relying on its legal advisers, although Pelephone has good defense arguments, the outcome of the proceeding cannot be assessed at this stage.

- (22) Further to Note 19A(36) to the financial statements as at December 31, 2004, concerning a claim filed in the Tel Aviv District Court against DBS, in the matter of payments to cover the electricity consumption of installations for reception of the broadcasts of DBS in condominiums, and the application for approval as a class action, on April 28, 2005, the parties filed an agreed application to strike the action and the application for approval as a class action without an order to pay costs. On May 1, 2005, the claim and the application for approval were struck from the record without an order to pay costs.

- (23) On June 30, 2005, the Cable and Satellite Broadcasting Council ("the Council") published its decision concerning an "Invitation to present position papers in the matter of the rules of ownership of the channels produced in Israel", in which the Council invites the public to present its positions on the matter, including the question of whether limitations should be imposed on DBS for the production of channels, as are imposed today only on the cable companies, and if so, what changes and modifications should be made in the rules compared with those applied today to the cable companies. In July 2005 DBS submitted its position to the Council, including its opinion that there is no justification for imposing limitations beyond those currently laid down in the law.

- (24) In 2001, the Ministry of Communications issued an administrative order regulating the method of transfer of a subscriber from the services of the cable companies to DBS and vice-versa, and the use of infrastructure in the subscriber's home. The administrative instructions also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider. Since enactment of the Administrative Instructions, DBS and the cable companies have brought mutual complaints regarding breach of the Administrative Instructions by the other party, and considerable correspondence has taken place between DBS and the Ministry of Communications in this regard. On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable companies that in light of their many breaches of the Administrative Instructions, 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 Instructions should remain in place, 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

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

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 companies title to the wiring installed by them in private homes. DBS also claimed that the sum set out in the Law as the consideration to be paid for purchase of the wiring (NIS 120) has no basis and that should the provision remain in force, it should be reduced considerably. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and has many faults, and will prevent the proper transfer of subscribers under it, and will harm competition.

- (25) Further to Note 19C(2) to the financial statements as at December 31, 2004, concerning a bank guarantee in the amount of \$10 million in accordance with the Company's general license, 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 foreclose on NIS 10 million out of the \$10 million bank guarantee provided by the Company in accordance with its general license. According to the Director General's notice, the decision to foreclose was made in light of the fact that the Company made a commitment to the institutional investors who extended loans to DBS, in which the Company holds approximately 49.8% of the shares, in contravention of the directives of the Minister of Communications.

It should be noted that since the decision of the Minister of Communications to impose limitations and conditions on the Company's transfer of funds to DBS, both DBS and the Company have acted, irrespective of their legal position concerning the lack of authority of the Minister of Communications to intervene on the matter of the transfers by shareholders and other financing entities to DBS, in order to comply with the terms and limitations imposed both by the Minister of Communications and by the Antitrust Commissioner, concurrently with the legal proceedings they instituted in the High Court of Justice and in the Antitrust Tribunal – as described in Note 4 above. The position of the Company is that there is no legal or other basis for the foreclosure of part of the guarantee of which the Director General of the Ministry of Communications notified the Company, and therefore no provision has been made in the financial statements. An appeal has been filed with the Minister of Communications against the decision and as a result, the foreclosure is meantime suspended. It is noted that the hearing of the petitions of the Company and DBS in the High Court of Justice against the Minister of Communications was held on October 11, 2005, however no decision has been given on this proceeding.

(26) The "industrial espionage" affair

On May 29, 2005, the media published a news item stating that the Government of Israel is conducting an investigation into "industrial espionage" by computerized means (a "Trojan horse" program), in which it was stated that the Company's subsidiaries Pelephone, Bezeq International and DBS, were involved:

- a. On May 31, 2005, the cable companies ("HOT") filed an *ex parte* application ("the First Application") in the Tel Aviv District Court, in which the court was requested to grant, *inter alia*, an order for the appointment of a receiver, who would be authorized to search and seize commercial secrets of HOT at all the sites operated by DBS and other information of HOT which is confidential or lawfully concealed, as well as other temporary reliefs, mainly to forbid DBS from making use of the commercial secrets of HOT.

The background to the application filed by HOT was newspaper articles about the "industrial espionage" affair conducted by means of Trojan horse software, where according to HOT, DBS appears to have acted illegally, through the Modi'in Ezrachi private investigations firm with which it had signed an agreement, so as to enable it to obtain confidential information of HOT while perpetrating the tort of commercial robbery. As part of the affair, the CFO of DBS, Mr. Katriel Moriah, was detained (and later released).

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(26) The "industrial espionage" affair (Contd.)

After dismissal of its application, HOT filed a "revised" *ex parte* application ("the Second Application"), in which it repeated its request, this time stating that its allegations are not based solely on reports in the media as it alleged in the First Application, but also on information conveyed to it by Israeli Police investigators. At the same time HOT also filed a statement of claim against DBS, which does not include an application for any financial relief and in which the court is requested to grant various declaratory reliefs and mandamuses and injunctions to prohibit DBS from making use of HOT's commercial secrets.

In its response to the application, DBS rejected the allegations of HOT and gave notice that without waiving any claim of its claims it is willing to undertake to refrain from making any use of documents relating to the business of HOT which it received from Modi'in Ezrachi, and that if any such document or information is found, that document will be signed, as is, and placed in an envelope and stored in the safe in the office of DBS's legal representative without any use being made of it. In a hearing held on July 7, 2005, and with the consent of the parties, the court made a decision to validate DBS's notice not to make any use of documents and information conveyed to DBS by Modi'in Ezrachi as an order. In this way, the court in fact dismissed the applications of HOT for the appointment of a receiver and the provision of a broader temporary injunction of the undertaking made by DBS.

On June 30, 2005, DBS filed a statement of defense in the court, in which it denies the allegations made by HOT in the statement of claim. A date for the hearing the claim has not yet been scheduled. DBS believes, based on its legal advisers, that at this stage the chances of the outcome of the claim cannot be estimated.

- b. On May 31, 2005, three employees of Bezeq International were called in for questioning as part of the Israeli Police investigation into the industrial espionage by computerized means (a Trojan horse program). Subsequent to being questioned, the employees were released under restriction. Up to the date of publication of the interim financial statements, no action has been taken against Bezeq International and/or its employees which relates to the aforementioned investigation.
- c. In November 2005 a claim was filed in the Tel Aviv District Court against Pelephone and against Modi'in Ezrachi, for grant of an order to provide a report, together with an application to separate reliefs. The cause of claim revolved around allegations that Pelephone has allegedly requested commercial information about the plaintiff's business and this was provided by Modi'in Ezrachi by infringing a number of laws and as part of the mask of the Trojan horse incident. At this stage, Pelephone is unable to estimate the chances and implications of the claim.

It should be noted that a number of senior employees of the Company were summoned, immediately after publication of the affair, to the police to make statements regarding confidential Company documents which were found on the premises of competing entities and to assess the extent of probable damage to the Company as a result. The Company studied the matter, and took immediate actions with the purpose of reducing as much as possible the risk of information unlawfully being taken out of the Company.

B. SECURITIES, LIENS AND GUARANTEES

1. In connection with three loan agreements signed between DBS and institutional bodies in March-April 2005, for a total amount of NIS 50 million, with an option to extend additional loans of up to an additional NIS 50 million as described in Note 4 above, the Company undertook that if the loans are not promptly repaid (in full or in part), or if certain other conditions exist (if a final decision is given by the court or a valid decision is made to liquidate DBS, if a receiver is

Notes to the Financial Statements as at September 30, 2005

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

B. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

appointed for DBS and/or for all or a material part of its assets, in any case where the guarantee provided to the banks is foreclosed or realized, if the Company sells all its holdings in DBS and in respect of a loan to one institutional body also in a case of transfer of control of the Company from the State to another, and provided six months have not elapsed from the date of actual transfer of the control to the provision of the lender's notice), the lenders will be able to demand repayment of the lower of the amount of the loan balance (principal, interest and linkage differences) and the amount calculated according to a predetermined formula which takes into account the value of DBS to its shareholders at that time.

2. On the matter of loans which the lenders may call for immediate repayment, see Note 1F.

C. COMMITMENTS

Further to Note 19B(7) to the financial statements as at December 31, 2004, concerning Pelephone winning a tender issued by the Accountant General at the Ministry of Finance (hereinafter – the AG) for the provision of cellular services to the various government ministries, for a period of three years commencing April 2005. The tender includes an option for the AG to extend the agreement for an additional three years. Under the agreement, Pelephone will supply subscriber equipment and cellular services for approximately 25,000 subscribers. The cost of purchasing the subscribers in the AG transaction, in the amount of NIS 30 million for supplying subscriber equipment, was charged to the statement of operations in the first quarter. During the second quarter most of the handsets were supplied to the AG.

D. FUTURES TRANSACTIONS

Forward Currency Transactions – Hedging Transactions

Consolidated

	<u>Currency purchased</u>	<u>Currency payable</u>	<u>Final repayment date</u>	<u>Amounts receivable</u>	<u>Amounts payable</u>
	<u>NIS millions</u>				
Currency exchange contracts at predetermined interest rates	Euro	CPI-linked NIS	October 2005	29	29
Forward contracts at predetermined exchange rate (excluding premium/discount)	Dollar	Shekel	September 2006	507	499
	Euro	Shekel	September 2006	1,498	1,570
	CPI-linked NIS	Shekel	January 2006	522	519

NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27 to the financial statements as at December 31, 2004, concerning advanced negotiations with the Ministry of Defense in the matter of a new agreement for the provision of communication services – a new commercial agreement was signed on May 8, 2005, between the Company and the Ministry of Defense in the name of the State of Israel, for the provision of communication services by the Company. The agreement was approved in advance by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and was subject to approval of the general meeting of the shareholders of the Company (by a special majority), as stipulated in the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. On June 2, 2005, the general meeting of the Company resolved to remove the subject from its agenda at the request of the Company, in view of the approach made by the Ministry of Communications and the request of the State following the request to postpone the discussion. The request of the Ministry of Communications stated, *inter alia*, that under the agreement,

Notes to the Financial Statements as at September 30, 2005

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

A. (Contd.)

discounts would be given which appear to be in contravention of the provisions of the law and the Company's license. The Ministry requested the response of the Company in order to clarify the matter. The Company submitted its remarks to the Ministry, stating that in its opinion, it was an agreement under a new framework which replaced the previous framework agreement, under which the Company also gave discounts of various percentages to the IDF. The Company pointed out that its license allows it to enter into a special agreement with the Ministry of Defense for the provision of telecommunications services to the IDF which includes any term agreed upon by the parties, including the provision of discounts, as was provided for in the previous framework agreement. The Ministry of Communications has not yet completed its examination of the matter.

In addition, the Company also received a letter from the Antitrust Commissioner stating that the agreement appears to contravene the provisions of the Antitrust Law. The Company submitted its response to the Commissioner. As at the date of approval of the financial statements, the Company intends, in coordination with the Ministry of Defense, to look into other alternatives to the agreement.

- B.** Further to Note 27B to the financial statements as at December 31, 2004, concerning a claim filed by the Company against the Ministry of Defense for payment of amounts in connection with a dispute on the matter of an 18% discount which the Ministry of Defense deducted from payments collected by the Company or other communications providers, in April 2005 a settlement agreement was signed after approval 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 arrangement on June 2, 2005, in accordance with the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. In June 2005 the settlement agreement was approved by the court which validated it as a court judgment.

The main points of the settlement agreement are as follows:

- (1) To settle a financial claim for approximately NIS 37.4 million (principal) plus interest in an amount estimated at approximately NIS 20 million, which was filed by the Company against the State in the matter of the deduction of discounts of 18% on various charges included under the "Miscellaneous" section in the telephone bills of the IDF, the Ministry of Defense will pay a total of NIS 28.5 million (including VAT if applicable), in three equal installments of NIS 9.5 million each, which will be paid by the following dates: June 30, 2005, January 31, 2006 and June 30, 2006.
- (2) Arrears in any of the payments will incur payment of Accountant General's interest on arrears.
- (3) Subject to the aforesaid, neither party shall have any allegation and/or demand and/or claim against the other on this matter.

Following the settlement agreement, the Company canceled a provision of approximately NIS 15 million.

C. BENEFITS FOR COMPANY OFFICERS

- (1) On April 6, 2005, the general meeting of the shareholders approved the Company entering into a commitment for indemnification in respect of a financial liability imposed upon officers in the Company and in respect of reasonable litigation expenses which they incur; in all matters connected, directly or indirectly, with the process of the sale of the State's holdings in the Company.

The undertaking to indemnify will be granted to officers who served and/or were appointed and/or will be appointed in the Company starting from the commencement of the Company's preparation for the sale process and until the date of closing the sale process.

The overall scope of the indemnity will not exceed 25% of the shareholders' equity of the Company (according to its 2004 financial statements, linked to the Consumer Price Index of

Notes to the Financial Statements as at September 30, 2005

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

C. BENEFITS FOR COMPANY OFFICERS (CONTD.)

(1) Contd.)

November 2004), including in respect of undertakings to indemnify which were made in advance up to the date of issue of the indemnity note together with the advance undertaking to indemnify in accordance with the letter of the Minister of Finance dated April 21, 2004, which will be given, if given, prior to transfer of the controlling interest in the Company by the State.

(2) On May 16, 2005, the meeting of the shareholders of the Company gave its approval to insure and indemnify the officers of the Company as follows:

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

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

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

(3) Limits of liability:

a. for the first three years, cover has a limited liability of \$150 million plus \$30 million in respect of legal expenses in Israel only;

b. for an additional three years cover has a limited liability of \$75 million plus \$15 million in respect of legal expenses in Israel only;

c. for the seventh year, cover has a limited liability of \$25 million plus \$5 million in respect of legal expenses in Israel only.

It is clarified that there is one limit of liability for the entire run-off period.

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

b. The approval of provision to make a commitment in advance to indemnify the officers of the Company who were serving in the Company at the time of making the commitment to indemnify, which will apply on the date of closing the sale, or who served during the seven years prior to that date, is in respect of a financial liability imposed upon them in each of the events listed in the indemnity document and on the terms set out therein, in which the officer acted in good faith and had reasonable grounds for assuming that the action is in the best interests of the Company. The undertaking to indemnify will not apply regarding an event for which an insurer acknowledges liability under an insurance policy, but if the officer was ordered, in respect of an event which could be indemnified, to pay an amount exceeding the amount he was paid by the insurer, the Company will indemnify him with the difference, subject to the amount of the indemnity for all the officers in the Company not exceeding \$150 million plus \$30 million in respect of legal expenses in Israel only, per claim, and in total for each year of insurance during the period of insurance. Upon the closing the transaction for sale of the State's holdings to Ap.Sb.Ar (October 11, 2005), this commitment came into force.

The above resolutions were approved and implemented effective from the date of closing the sale (October 11, 2005).

Notes to the Financial Statements as at September 30, 2005

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

C. BENEFITS FOR COMPANY OFFICERS (CONTD.)

(2) Contd.)

It should be noted that in May 2005, a shareholder in the Company (who holds approximately 0.12% of the Company's shares) filed a claim against the Company, the State of Israel, shareholders in the Company and officers who are entitled to insurance and indemnity as aforesaid, for grant of declaratory relief in that the aforementioned resolutions of the general meeting are void, since they were adopted unlawfully, and since the State has a personal interest in the resolution, and since grant of the indemnification is most exceptional and the insurance involves high costs. The plaintiff later withdrew its claim.

(3) On August 3, 2005, the Special General Meeting of the shareholders of the Company approved extension of the officers' insurance policy, including a run-off option, for a period of up to 4 months, at a cost of \$112,500 per month, commencing July 31, 2005 (the date of expiry of the previous policy). With the closing of the transaction for sale of the State's shares to Ap.Sb.Ar. (October 11, 2005), the run-off option was exercised as detailed in section 2(a) above, and that policy expired.

(4) On October 11, 2005, and on November 2, 2005, the Audit Committee and the Board of Directors resolved to:

a. Purchase a policy for insurance the liability of officers in the Company for a period of one year, commencing October 11, 2005, with a limit of liability of \$150 million for any one claim and in total for each year of insurance.. In addition, \$30 million per claim and for the total amount of claims for the period of insurance in respect of legal expenses in Israel only. Limit of liability for subsidiaries – \$50 million (as part of the aforementioned limit of liability). Annual premium - \$675,000 + 1.5% stamp duty. (It should be noted that the extent of the insurance cover is the same as the officers' insurance which has been provided by the Company up to this date, whereas the annual premium is considerably lower than the premium paid in the past due to the existence of the concurrent run-off insurance.)

b. A "framework transaction" for the Company's commitment during the normal course of business, in future insurance policies (after expiry of the current policy referred to in paragraph a. above), to cover the liability of directors and officers, as may be from time to time, including directors and officers who are or could be considered controlling shareholders in the Company, and all by way of a "framework transaction" as that term is defined in the Companies Regulations (Benefits in transactions with interested parties), 5760-2000, at an annual premium of \$675,000 plus 20% of that premium in respect of the existing sum of insurance today (set out in paragraph 2a. above).

These resolutions require the approval of the General meeting of the shareholders, which has been called for November 24, 2005.

Notes to the Financial Statements as at September 30, 2005

NOTE 8 – REVENUES FROM COMMUNICATION SERVICES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services –					
Fixed-line communications - traffic	1,083,535	1,200,897	367,075	367,569	1,567,631
Fixed fees	1,914,818	1,854,860	647,254	624,844	2,501,250
Cellular telephone	2,740,753	1,758,393	916,766	707,500	2,699,876
International communications and internet services	571,918	584,336	191,163	205,284	771,290
Multi-channel television	895,586	257,578	319,450	257,578	529,838
Installation and sale of equipment to subscribers	871,143	531,138	313,403	204,659	825,390
Miscellaneous	68,900	61,466	17,484	23,919	89,448
	8,146,653	6,248,668	2,772,595	2,391,353	8,984,723
	192,564	245,576	66,124	82,110	285,081
Other revenues	8,339,217	6,494,244	2,838,719	2,473,463	9,269,804

Notes to the Financial Statements as at September 30, 2005

NOTE 9 – OPERATING AND GENERAL EXPENSES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and incidental expenses –					
Operations	1,325,596	1,115,433	450,121	397,952	1,578,426
General and administrative	500,269	394,062	173,572	149,748	549,869
Total salaries and related expenses	1,825,865	1,509,495	623,693	547,700	2,128,295
General expenses	927,518	638,313	313,775	269,353	996,323
Materials and spare parts	743,914	426,992	244,759	155,548	643,013
Consumption of content from satellite services	309,533	94,476	107,282	94,476	200,469
Cellular telephone expenses	733,253	429,348	255,611	177,923	700,890
Building maintenance	264,132	248,530	94,327	95,354	352,430
Services and maintenance by sub- contractors	329,483	243,973	118,846	107,698	341,999
International communications expenses	199,839	168,714	69,718	65,223	228,936
Vehicle maintenance expenses	131,481	97,673	50,317	36,925	144,630
Collection fees	37,597	29,396	12,842	10,485	39,357
	5,502,615	3,886,910	1,891,170	1,560,685	5,776,342
Less – salaries charged to investment in fixed assets	161,479	151,976	55,686	49,731	211,252
	5,341,136	3,734,934	1,835,484	1,510,954	5,565,090

NOTE 10 – OTHER INCOME (EXPENSES), NET

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Provision for claims for salary and pension components	–	145,000	–	145,000	207,000
Provision for employee severance benefits upon early retirement	83,000	(30,000)	–	–	(105,000)
Provision for impairment and other liabilities in respect of the value of investments in other companies	(5,868)	–	(1,168)	–	(26,000)
Compensation in respect of a settlement agreement	14,483	–	–	–	–
Amortization of goodwill	(69,837)	(16,554)	(23,278)	(16,190)	(35,135)
Capital gain from sale of operation (1)	103,869	–	–	–	35,033
Capital gains, net	5,346	7,143	2,579	7,539	7,338
Others	(339)	3,350	(221)	(4,409)	(3,556)
	130,654	108,939	(22,088)	131,940	79,680

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

Notes to the Financial Statements as at September 30, 2005

NOTE 11 – INCOME TAX

- a. On July 25, 2005 the Knesset passed the Income Tax Ordinance Amendment Law (No. 147 Temporary Order), 5765-2005 ("the Amendment"), which prescribes a gradual reduction of the corporate tax rate in the following manner:

In the 2006 tax year the tax rate will be 31%, in 2007 it will be 29%, in 2008 it will be 27%, in 2009 it will be 26% and from 2010 onwards the tax rate will be 25%.

The current taxes and deferred tax balances as at September 30, 2005, are computed according to the new tax rates as determined in the above Amendment. The effect of the change on the consolidated financial statements in the third quarter of 2005 is an increase in income tax expenses on revenues in the statement of operations and a decrease in the deferred taxes included in the balance sheet, of approximately NIS 45 million Company and approximately NIS 40 million consolidated.

- b. In November 2005 Bezeq International and the Income Tax Authorities signed a final assessment agreement for the years 2000 – 2003 (inclusive). Under that agreement, the business loss carried forward of Bezeq International as at December 31, 2004, was reduced by approximately NIS 25 million, so that the revised business loss of Bezeq International to be carried forward to subsequent years is approximately NIS 25 million as at December 31, 2004. The amount deducted from the business loss is recognizable by Bezeq International as a tax expense in subsequent coming years.
- c. In the three-month period ended September 30, 2005, Bezeq International charged deferred tax assets against deferred tax revenues in the amount of approximately NIS 18.7 million, due to Bezeq International's assessment that in the foreseeable future, it expects to utilize tax benefits in respect of which deferred taxes were not charged the past.

Notes to the Financial Statements as at September 30, 2005

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. STATEMENTS OF OPERATIONS

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005 (Unaudited)	2004 (Unaudited)	2005 (Unaudited)	2004 (Unaudited)	2004 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues (Note 12B)	3,566,204	3,750,806	1,211,014	1,228,658	4,959,691
Costs and expenses					
Operating and general expenses (Note 12C)	1,733,455	1,728,223	604,220	588,374	2,347,448
Depreciation	1,047,889	1,130,465	347,411	374,119	1,495,909
Royalties to the Government of Israel	104,021	109,849	33,915	35,276	145,318
	2,885,365	2,968,537	985,546	997,769	3,988,675
Operating income	680,839	782,269	225,468	230,889	971,016
Financing revenues (expenses), net	(28,448)	(64,791)	2,575	(33,557)	(93,216)
Earnings after financing expenses	652,391	717,478	228,043	197,332	877,800
Other revenues, net	200,855	120,061	1,455	148,418	109,904
Earnings before income tax	853,246	837,539	229,498	345,750	987,704
Income tax	(298,087)	(354,034)	(99,399)	(125,163)	(387,079)
Earnings after income tax	555,159	483,505	130,099	220,587	600,625
Company's equity in earnings (losses) of investee companies	(23,000)	33,368	(26,950)	22,063	20,200
Earnings before the cumulative effect of change in accounting method	532,159	516,873	103,149	242,650	620,825
Cumulative effect of change in accounting method as at the beginning of the year*	15,000	–	–	–	–
Net earnings	547,159	516,873	103,149	242,650	620,825

* See Note 2B

Notes to the Financial Statements as at September 30, 2005

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

B. REVENUES FROM COMMUNICATION SERVICES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Fixed-line domestic communications -					
Traffic	1,121,254	1,211,001	377,184	371,514	1,590,671
Fixed fees	1,797,867	1,764,778	607,442	595,709	2,354,700
Total revenues from fixed-line communications	2,919,121	2,975,779	984,626	967,223	3,945,371
Cellular telephone	280,050	325,175	94,584	105,907	414,740
International communications	82,476	97,727	28,498	31,712	126,856
Installation and sale of equipment to subscribers and miscellaneous	120,205	195,177	45,931	67,512	266,980
	3,401,852	3,593,858	1,153,639	1,172,354	4,753,947
Other revenues	164,352	156,948	57,375	56,304	205,744
	3,566,204	3,750,806	1,211,014	1,228,658	4,959,691

C. OPERATING AND GENERAL EXPENSES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses –					
Operations	834,499	837,315	282,128	274,407	1,122,381
General and administrative	207,445	206,264	70,672	70,309	271,310
Total salaries and related expenses	1,041,944	1,043,579	352,800	344,716	1,393,691
General expenses	232,556	247,186	78,522	89,693	341,977
Materials and spare parts	60,812	84,944	22,437	22,149	114,443
Building maintenance	236,342	224,612	83,254	84,220	315,074
Services and maintenance by sub- contractors	157,623	158,666	54,636	55,875	205,192
International communications expenses	22,478	16,692	12,603	7,352	27,105
Vehicle maintenance expenses	94,378	77,510	36,971	25,784	111,359
Collection fees	27,868	27,010	9,630	8,316	36,904
	1,874,001	1,880,199	650,853	638,105	2,545,745
Less– salaries charged to investments in fixed assets	140,546	151,976	46,633	49,731	198,297
	1,733,455	1,728,223	604,220	588,374	2,347,448

Notes to the Financial Statements as at September 30, 2005

NOTE 13 – BUSINESS SEGMENTS

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

For the nine-month period ended September 30, 2005

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

For the nine-month period ended September 30, 2004

	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Multi- channel television	Others	Adjustments	Consolidated
Revenues							
Revenues from external sources	3,593,126	1,859,073	601,214	260,608	180,223	–	6,494,244
Inter-segment revenues	157,680	5,189	12,991	8,092	52,651	(236,603)	–
Total revenues	3,750,806	1,864,262	614,205	268,700	232,874	(236,603)	6,494,244
Segment results*	782,269	257,489	93,308	(32,711)	8,041	–	1,108,396

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

Notes to the Financial Statements as at September 30, 2005

NOTE 13 – BUSINESS SEGMENTS (CONTD.)

For the three-month period ended September 30, 2005							
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
Revenues							
Revenues from external sources	1,144,535	1,139,297	195,157	304,867	54,863	–	2,838,719
Inter-segment revenues	66,479	3,232	6,432	5,786	28,747	(110,676)	–
Total revenues	1,211,014	1,142,529	201,589	310,653	83,610	(110,676)	2,838,719
Segment results*	225,468	129,725	26,038	(28,970)	(2,235)	–	350,026
For the three-month period ended September 30, 2004							
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
Revenues							
Revenues from external sources	1,172,430	784,287	204,576	260,608	51,562	–	2,473,463
Inter-segment revenues	56,228	2,063	8,586	8,092	29,811	(104,780)	–
Total revenues	1,228,658	786,350	213,162	268,700	81,373	(104,780)	2,473,463
Segment results*	230,889	117,482	26,749	(32,711)	4,036	–	346,445
For the year ended December 30, 2004							
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
Revenues							
Revenues from external sources	4,736,756	2,966,486	797,735	529,838	238,989	–	9,269,804
Inter-segment revenues	222,935	8,493	18,704	12,304	80,387	(342,823)	–
Total revenues	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Segment results*	971,016	379,328	118,223	(85,381)	8,362	–	1,391,548

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

Notes to the Financial Statements as at September 30, 2005

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

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheet

	September 30 2005	September 30 2004	December 31 2004
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	1,882,739	1,324,025	1,413,049
Long-term trade receivables	339,872	258,066	278,778
Investment in investee companies	3,216	4,429	4,084
Deferred income tax	33,322	111,786	106,503
Fixed assets, net	3,029,525	3,014,294	3,093,675
Other assets	336,925	359,826	334,028
	5,625,599	5,072,426	5,230,117
Current liabilities	1,571,287	1,800,390	1,794,413
Long-term liabilities	1,721,223	1,210,602	1,305,674
Shareholders' equity	2,333,089	2,061,434	2,130,030
	5,625,599	5,072,426	5,230,117

Notes to the Financial Statements as at September 30, 2005

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

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. Statement of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from Pelephone services, sales and services	3,354,322	3,301,627	1,142,530	1,145,804	4,412,344
Cost of Pelephone services, sales and services	2,557,693	2,412,616*	871,563	839,650*	3,258,877*
Gross profit	796,629	889,011	270,967	306,154	1,153,467
Sales and marketing expenses	330,155	355,115*	114,983	118,262*	470,408*
General and administrative expenses	76,232	95,918*	26,264	28,529*	123,935*
Operating income	390,242	437,978	129,720	159,363	559,124
Financing expenses, net	(82,277)	(82,389)	(42,829)	(19,445)	(99,597)
Other income, net	497	3,084	390	212	3,645
Earnings before income tax	308,462	358,673	87,281	140,130	463,172
Income tax	(96,855)	(120,194)	(23,860)	(46,394)	(153,400)
Earnings after income tax	211,607	238,479	63,421	93,736	309,772
Company's equity in losses of an affiliate	(8,548)	(6,383)	(2,140)	(3,101)	(9,080)
Net earnings	203,059	232,096	61,281	90,635	300,692

* Reclassified

Notes to the Financial Statements as at September 30, 2005

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

2. DBS SATELLITE SERVICES (1998) LTD.

A. Balance sheet

	September 30 2005 (Unaudited)	September 30 2004 (Unaudited)	December 31 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	142,114	123,300	124,393
Broadcasting rights, net	161,339	128,410	140,496
Fixed assets, net	1,071,672	1,097,219	1,102,066
	1,375,125	1,348,929	1,366,955
Current liabilities	617,877	1,886,458	595,229
Long-term liabilities	1,376,272	16,596	1,299,138
Loans from shareholders	2,850,274	2,552,036	2,661,540
Capital deficit	(3,469,298)	(3,106,161)	(3,188,952)
	1,375,125	1,348,929	1,366,955

Notes to the Financial Statements as at September 30, 2005

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

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

B. Statement of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from DBS services	895,585	754,550	310,652	268,680	1,027,992
DBS operating expenses	799,940	746,934	276,143	248,081	1,013,403
Gross profit	95,645	7,616	34,509	20,599	14,589
Sales and marketing expenses	107,282	95,007	40,575	34,234	133,511
General and administrative expenses	57,640	53,150	19,650	17,092	72,240
	164,922	148,157	60,225	51,326	205,751
Operating loss	(69,277)	(140,541)	(25,716)	(30,727)	(191,162)
Financing expenses, net	(174,064)	(134,556)	(73,263)	(40,252)	(171,522)
Other expenses, net	(568)	(2,258)	(480)	(888)	(3,200)
Net loss	(243,909)	(277,355)	(99,459)	(71,867)	(365,884)

Notes to the Financial Statements as at September 30, 2005

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

3. BEZEQ INTERNATIONAL LTD.

A. Balance sheet

	September 30 2005 (Unaudited)	September 30 2004 (Unaudited)	December 31 2004 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	320,208	199,926*	223,302*
Long-term investments and debit balances	28,619	27,740*	26,684*
Fixed assets	317,273	352,919	355,439
Other assets	23,930	19,848	18,106
	690,030	600,433	623,531
Current liabilities	218,317	242,258	239,133
Long-term liabilities	186,269	182,524	181,982
Shareholders' equity	285,444	175,651	202,416
	690,030	600,433	623,531

* Reclassified.

Notes to the Financial Statements as at September 30, 2005

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

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. Statement of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2005	2004	2005	2004	2004
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunication services	604,132	614,205	201,589	213,162	816,439
Operating expenses	394,064	382,421*	127,592	135,472*	506,779*
Gross profit	210,068	231,784	73,997	77,690	309,660
Marketing, general and administrative expenses	141,146	138,476*	47,959	50,041*	191,437*
Operating income	68,922	93,308	26,038	27,649	118,223
Financing income (expenses), net	(3,388)	(4,516)	175	(829)	(4,301)
Earnings after financing, net	65,534	88,792	26,213	26,820	113,922
Other revenues (expenses), net	63	5,138	17	555	4,656
Earnings before income tax	65,597	93,930	26,230	27,375	118,578
Tax benefit (Income tax)	17,678	(500)	7,700	(46)	822
Earnings after income tax	83,275	93,430	33,930	27,329	119,400
Company's equity in earnings of an affiliated company	2,940	1,141	1,643	303	1,440
Net earnings	86,215	94,571	35,573	27,632	120,840

* Reclassified.