August 2, 2005

# "Bezeq" The Israel Telecommunication Corp. Limited

# Quarterly Report for the period ending 30.6.05

**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 June 30, 2005**

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

# UPDATE OF CHAPTER A (DESCRIPTION OF COMPANY OPERATIONS)[1] OF 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

Section 1.1.5 of the period Report in the matter of the merger of the subsidiary D.B.S. Satellite Services (1998) Ltd. ("DBS"), notes that the Company applied to the Jerusalem District Court for a declaratory decision determining that the decisions of the Ministers of Communications which limited the Company's transfers into DBS were issued *ultra vires* and are therefore void. On March 20, 2005, the District Court ruled that the competent court for hearing the case is the High Court of Justice, and accordingly, it transferred the proceeding to that court. Accordingly, on April 17. 2005, the Company filed an application with the Supreme Court for leave to appeal the decision of the District Court and an application to turn the claim, should the application for leave to appeal be dismissed, into a High Court of Justice petition. The application for leave to appeal the decision of the District Court was dismissed, and on May 10, 2005, a petition was filed with the High Court of Justice.

It is noted that DBS also filed a petition in the High Court of Justice on the same matter. The cable companies were joined as respondents to the petitions, the hearing for which has been set for October 11, 2005.

On the matter of the conditional approval of the Antitrust Commissioner for the merger, on March 14, 2005, the Company and DBS filed appeals against the conditions for the merger. The cable companies filed an application to join the proceedings and their application was rejected on July 25, 2005. On March 15, 2005, the cable companies, for their part, also filed an appeal against approval of the merger. The Company's and DBS's applications to strike out this appeal *in limine* were dismissed on July 25, 2005. The appeals filed by the Company and DBS are to be heard on September 22, 2005.

For a detailed description of developments in this area, including regarding a letter from the Antitrust Commissioner to the Company dated July 25, 2005, see Note 4 to the financial statements of the Company for the period ended June 30, 2005.

### Section 1.3 – Investments in Equity and Stock Transactions

Further to Sections 1.3.4 and 2.20 of the Periodic Report on the matter of the privatization of the Company, the Company has been given notice by the Director of the Government Companies Authority to the effect that, on May 9, 2005, two groups submitted offers for purchase of 30% of the Company's share capital and options to acquire another 10.66%of the share capital of the Company from the State of Israel (the "State's Holdings") and the State has chosen Ap. Sab. Ar. Holdings Ltd. ("Ap. Sab. Ar."), which offered NIS 4,237,000,000 for the State's Holdings, as the preferred bidder. Transfer of the State's Holdings to Ap. Sab. Ar. requires the receipt of consents under all laws and in particular, the approval of the Prime Minister and of 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 Telecommunication Corp. Limited) Order, 5757-1997 (the "Telecommunications

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

Order") and the consent of the Antitrust Commissioner under the Antitrust Law, 5748-1988. Upon receipt of all of the necessary consents, the State shall transfer the State's Holdings to Ap. Sab. Ar. in return for payment of the offered price, plus Accountant General's interest from the date of submission of the offer during the sale proceedings until the date of transfer of the holdings to Ap. Sab. Ar. Details of the conditions of exercise of the options have been provided to the Company by the Director of the Government Companies Authority, as set out in the Company's Immediate Report of July 14, 2005.

It is noted that the Antirust Commissioner's consent to the transaction was given on May 17, 2005.

Following the "industrial espionage" incident (see in this regard section 2.20(b) below) and disputes that have arisen between the State and Ap. Sab. 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. Sab. Ar. as conditions of completion of the transaction. Based on a notice from the Government Companies Authority, this agreement has implications in respect of the exercise price of the options received by Ap. Sab. Ar., to the extent that they might relate to and result from the aforementioned incident, plus the accrual of interest on the transaction price through the completion of it. For this matter, see the Company's Immediate Reports dated July 10, 2005 and July 14, 2005.

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

## Section 1.4 – Distribution of Dividends

Further to Section 1.4.4 of the Periodic Report in the matter of an undertaking by the buyer of the controlling interest in the Company to act by virtue of his holdings in relation to distribution, it was clarified to the participants in the privatization proceeding by the Director General of the Government Companies Authority, in a letter dated April 19, 2005, that the position of the Government Companies Authority is that no restrictions imposed on the buyer of the controlling interest should prevent 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' Union, in which the Chairman of the organization gives notice that the Company Workers' Union 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.

It is possible that after the closing of the sale transaction, agreement will be reached on this issue with the Workers Union.

## 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. The Company is considering the steps it should take in this regard.

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

### Section 2.2 – Products and Services

In the matter of Section 2.2.2 of the Periodic Report – Telephony, on April 21, 2005, the Company received a letter from the Director General of the Ministry of Communications, stating that after examining the various considerations and data submitted to the Ministry, the Minister is considering refusing to give her approval (contrary to the approval in principle given to the Company by the former Minister) to cease the provisions of the Bezeqcard service. The Company has 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 the 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. The date for submission of positions has been set down for August 10, 2005. The Company is formulating its response to this matter.

In the matter of Section 2.2.3 of the Periodic Report – Internet access services, as at June 30, 2005, the Company's ADSL subscribers number approximately 740,000 (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 process of the Company**

On April 6, 2005, a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the participants in the privatization process of the Company. The document contains explanations of the main questions raised by the participants in the privatization proceeding, based on the present policy of the Ministry 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 financial results of those operations.

On this matter, see also Note 1C(1) to the financial statements of the Company for the period ended June 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 of the Periodic report – on April 14, 2005, the Company has withdrawn its petition to the High Court of Justice. On this matter, see also Note 1C(4) to the financial statements of the Company for the period ended June 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.

**d. VOB Service Policy[2]**

Further to Section 2.6.1 of the Periodic Report, on April 20, 2005 the Ministry of Communications notified, *inter alia*, the Company and its subsidiaries that in completing preparation of the policy and following study of the remarks submitted in response to their enquiries, it is considering 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;
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 granted to Golden Lines until the hearing proceeding has ended.

[2] Voice Over Broadband

The Company has been invited to a hearing at the Ministry of Communications on August 7, 2005.

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 of the Periodic Report – after a joint discussion at the Ministry of Communications with the Company and the operators who wish to offer this service, the Ministry 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 one licensee and the Company is in advanced negotiations with other trial licensees for connecting them to the Company's network.

On June 23, 2005 the Company applied to the Ministry of Communications in order to respond to the information that a marketing trial license for the provision of VOIP services has been given to Cellcom and requested that, if possible, it be suspended at least until the completion of the hearing proceedings and the setting of policy.

**f.** **Numbering and number portability**

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

On April 20, 2005, the Ministry of Communications sent the licensees a draft numbering plan, which it is considering for implementation and operation, for their remarks. The draft set out milestones at which the licensee must have installed and operated all the means required for the application of number portability in its systems no later than January 31, 2006, will commence interconnect tests no later than February 1, 2006 and complete them no later than June 1, 2006, and will provide number portability to whoever requests it no later than August 1, 2006. On July 31, 2005 the Company provided the Ministry of Communications with its position to the effect that it would not be possible to meet the timetable outlined by the Ministry for implementation of the number portability plan, and that the Company is in the process of examining technological changes, and that against this background, investment at this time in implementation of number portability on the existing network and systems would be a cumbersome and unnecessary example of patchwork. The Company requests that a committee be set up to re-examine the timetable and the possibilities of implementing number portability and formulating a program, including changing the law.

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. Even though the date for the implementation of number portability has been extended beyond the date originally proposed in the Bill (which was February 2006), and with which the Company commented that it believes it will be unable to comply, it will nevertheless be difficult for the Company to ready itself for number portability even by the date approved by the Committee as aforesaid (even if extended to the end of 2006). In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the Company's ability to compete.

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

Further to Section 2.6.6(G) of the Periodic Report – on March 28, 2005, the High Court of Justice decided to leave in place the interim order for staying cancellation of the agreements between the Company and business customers 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 for November 17, 2005.

## <u>Section 2.9 – Human resources</u>

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

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

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

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

to the extent its approval is required for the agreement, the sale of the State's holdings will replace the approval.

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

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

b. In the matter of a one-time bonus to Company employees in the amount of half of the amount of the salary reduction in accordance with the 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 June 30, 2005.

## 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 4B to the Company’s financial statements for the period ended June 30, 2005.

## Section 2.13 – Finance

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

On April 4, 2005, the Company issued, through 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, 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).

### 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 in 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. Sab. 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. Sab. 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.

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. Sab. 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. Sab. 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. Sab. 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.

## Section 2.14 – Taxation

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

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. Regarding Section 2.16.1 – Regulation of Company tariffs, and Section 2.16.3 – concerning royalties – on March 29, 2005, the Knesset approved the amendments to the Communications Law described in those sections, as part of the Economic Policy Bill. 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. Regarding Section 2.16.1 of 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 the tariffs supervised by the Company 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.

   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.

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 of 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.

(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 the 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 code 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. Regarding Section 2.16.3 of 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 process 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 an urgent meeting 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(12) to the financial statements of the Company for the period ended June 30, 2005.

g. Concerning Section 2.16.10(b) of 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 by 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, there has been no material change in the overall volume of the installations.

(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 Mizrachi 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 of 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 all matters 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 June 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. 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 Notes 6A(1), 6A(12) and 6A(18) to the financial statements of the Company for the period ended June 30, 2005, and clause 1.1 above.

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

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

### The "Industrial Espionage" Incident

b. 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.

Bezeq International gave notice, in response to the summons to investigation of its employees, that it would give the Police any 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 from the investigation companies. Regarding DBS in this incident, see also Note 6A(19)(a) to the financial statements of the Company for the period ended June 30, 2005.

It should be noted that a number of senior employees of the Company were summoned to give evidence at 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 is examining this issue and its steps regarding its confidential material that is in the possession of its competitors.

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 during 2005, in a reduced manner at this stage.

### 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

Regarding 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.

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 share 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. On this matter, see also Section 2.6(d) and (e) above.

### Section 3.15 – Finance

On June 29, 2005, Pelephone issued NIS 333 million par value debentures by way of private placement to institutional investors, in return for their par value (see Note 1E(3) of the Company's financial statements for the period ended June 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 – Controlled tariffs – in partial compensation for reduction of the tariffs referred to in that section, on March 1, 2005 Pelephone raised the outgoing call tariff from the Pelephone network and on May 3, 2005 it raised the SMS tariff for outgoing messages from the Pelephone network.

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 a month. 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. On the matter of the petition filed in the High Court of Justice on this matter against the Government, Pelephone and others, se Note 6A(15) to the financial statements of the Company for the period ended June 30, 2005.

## Section 3.19 – Legal proceedings

For updates on legal proceedings, see Notes 6A(5), 6A(14) and 6A(15) to the financial statements of the Company for the period ended June 30, 2005.

## Section 3.21 – Expected developments in the coming year

Regarding the tender of the "Yoter" Soldiers' Welfare Association in section 3.21.3, a competing cellular company won that tender.

# 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 Section 2.20(b) above and Note 6A(19)(b) to the financial statements of the Company for the period ended June 30, 2005.

Regarding 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 4.4 – 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 the 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 the 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 (as a subsidiary of the Company) from providing VOB services until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and 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 telephony 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 4.17 – Limitation and regulation of Bezeq International activities

Regarding Section 4.17.1.3 of 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 of the Periodic Report, the Court recommended to the parties, in a pre-trial hearing on March 2, 2005, to make a further attempt at mediation and to notify it of their decision. However, this recommendation was rejected by the suppliers. The case is scheduled for the hearing of evidence and oral summations on September 20 and November 9, 2005.

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 of 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. Another pre-trial hearing is scheduled for September 2005.

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 of 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 the supplier of an additional system operated by Bezeq International and used for the supply of the service sunder the Claim.

For updates on other legal proceedings, see also Note 6A(14) to the financial statements of the Company for the period ended June 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 June 30, 2005 amounted to approximately 496,000.

For the "industrial espionage" incident see Section 2.20(b) above and Note 6A(19)A of the Company's financial statements for the period ended June 30, 2005.

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

Regarding 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 services, internet and fixed-line telephony.

## Section 5.6 – Competition

Further to Section 5.6.4 concerning positive and negative factors in competition – in the opinion of DBS the appropriate feasibility (including from engineering and economic aspects) of the advanced services, including video on demand, is possible by means of using a broadband infrastructure, but DBS has not yet received approval to provide these services commercially and the Ministry of Communications has announced that it believes such service would require legislative amendment. It is noted that the video on demand service has recently been launched by the cable companies to their digital service subscribers. In July 2005, DBS applied to the Ministry of Communications requesting a license for a marketing test for the provision of the said services in return for payment, to at least 10,000 subscribers, in addition to the application, not yet approved, to receive a commercial license for the provision of the above services. The Ministry of Communications' response to this has yet to be received.

## Section 5.8 – Intangible assets

Further to Section 5.8.1.2 of 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 of 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 of the Periodic Report – Organizational structure – As at the date of this report, the organizational structure of DBS has been changed so that DBS now consists of only eight divisions (rather than 10), 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 similar exception to those applicable to the shareholders' loans which the shareholders of DBS have made available and will make available after April 1, 2004. To secure repayment of the loans to the institutional bodies, the Company made a commitment (which is contingent, *inter alia*, on a positive value of DBS), and the banks that are financing DBS's operations agreed that in the event of realization of the Company's shares in DBS by them, the institutional bodies would be entitled to a proportional part of the proceeds, at the percentage determined in the agreements. The institutional bodies were also given an option to extent loans in the same amount as already extended, provided that the amounts of the loans are required according to the business plan of DBS. Concurrently with these agreements, appropriate amendments were also signed to 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.

On this matter, see also Note 4B and Note 6B to the financial statements of the Company for the period ended June 30, 2005.

Further to section 5.12.3 of 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 117 million and the banks have increased their credit by some NIS 14 million.

Further to Section 5.12.4 (credit of corporation) – DBS's credit allowance is approximately NIS 1,375 million. As at June 30, 2005, DBS has utilized NIS 1,362 million of its credit allowance.

## Section 5.14 – Restrictions and supervision of the corporation

Further to Section 5.14.1 of the Periodic Report, specific legal restrictions on operations – according to a decision of the 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 thousand and under-investment of approximately NIS 7,800 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 thousand and under-investment of approximately NIS 5,200 thousand 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.

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 of the Periodic 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.

## Section 5.15 – Material agreements

Further to Section 5.15.2 of the Periodic Report – pursuant to the Second Space Agreement (as defined in section 5.15.2 of 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, until solution of that limitation, rental is not being paid for the aforesaid eighth segment.

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

## Section 5.17 – Legal proceedings

Regarding Section 5.17.3 of the Periodic Report –

(a) On March 20, 2005, the District Court in Jerusalem held that jurisdiction to hear the claim filed by the Company in the matter of the decision of the Minister of Communications dated December 31, 2004, and the decision of the Minister of Communications dated February 14, 2005, obtained to the High Court of Justice (see update to clause 1.1 above). DBS subsequently filed a petition to in the same court on April 7, 2005, which has not yet been heard.

(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. At this stage, DBS's legal counsel are unable to assess how this dispute might end.

(c) For further updates on legal proceedings, see Notes 6A(16), 6A(17), and 6A(19)(a) to the financial statements of the Company for the period ended June 30, 2005, and Section 1.1 above.

August 2,2005 ________________________________
Date Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:
Hava Shechter, Member of the Board (Chairperson of the approval meeting)
Amnon Dick, CEO

August 2, 2005

# Directors Report on the State of the Company's Affairs for the period ended June 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 six-month period ending June 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 report and which were not included in the 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 June 30, 2005, amounted to approximately NIS 20.52 billion, compared with NIS 18.6 billion as at June 30, 2004. Of these, approximately NIS 10.33 billion (approximately 50.4%) are fixed assets compared with approximately NIS 9.38 billion (approximately 50.4%) on June 30, 2004. NIS 1.63 billion of the increase in the total assets originates from first time full consolidation of Pelephone.

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 report. Additionally, there was a decrease in cash balances and short-term investments compared with the prior year.

In the cellular segment, there were additional investments in fixed assets and an increase in cash, cash equivalents 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 past 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 and trade receivable 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 content rights and in the customer credit balance.

B. The Group's shareholders' equity as at June 30, 2005, amounted to approximately NIS 7.91 billion, comprising approximately 39% of the total balance sheet, compared with approximately NIS 7.12 billion as at June 30, 2004, which comprised approximately 38% 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 in the prior period.

C. Total Group debt to financial institutions and debenture holders as at June 30, 2005, amounted to approximately NIS 8.77 billion, compared with approximately NIS 7.30 billion on June 30, 2004. Approximately NIS 1.18 billion of this increase derives from the first-time full consolidation of Pelephone.

D. Group balances in cash and short-term investments as at June 30, 2005, amounted to approximately NIS 3.62 billion, compared with approximately NIS 4.40 billion on June 30, 2004. The decrease derives mainly from exercise of the option to purchase the second half of the shares of Pelephone. The decrease was offset by cash flows from current operations in the main segments of the Group's business and also from an issuance of debentures and receipt of loans.

## 2. Results of Operations

A. Principal Results

Net earnings for the first six months of 2005 amounted to approximately NIS 444 million, compared with net earnings of approximately NIS 274 million for the corresponding period in the prior year. The difference in the results derives mainly from the other income (expenses) item, where an expense of approximately NIS 23 million (before tax) was recorded in the corresponding period mainly in connection with early retirement costs and in the reported period, revenues of approximately NIS 153 million (before tax) were recorded, mainly capital gains of about NIS 107 million and a reduction in early retirement costs of approximately NIS 83 million.

The increase in net earnings was offset by a decrease in operating income and an increase in the financing expenses of the Group.

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

| | **For the six-month period ended June 30** | |
|---|---|---|
| **Segment** | **2005 NIS millions** | **2004 NIS millions** |
| Fixed-line domestic communications | 455 | 551 |
| Cellular[1] | 254 | 140 |
| International communications and internet services | 43 | 67 |
| Multi-channel television[2] | (50) | - |
| Others | 1 | 4 |

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

Net earnings per share for the first six months of 2005 amounted to NIS 0.170 per NIS 1.00 par value compared with net earnings per share of NIS 0.105 per NIS 1 par value in the corresponding period in the prior year.

B. Revenues

Group revenues in the first six months of 2005 amounted to approximately NIS 5.50 billion compared with earnings of approximately NIS 4.02 billion in the corresponding period in the prior year. The increase of approximately NIS 1.62 billion derives from first-time consolidation. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 2.52 billion in the first six months of 2004 to approximately NIS 2.36 billion in the period of report (a decrease of approximately 6.6%). 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 and a decrease in revenues from the sale of equipment to subscribers. The decrease in revenues was moderated by the ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL) and by a settlement agreement with a controlling customer (see Note 7B to the financial statements). The auditors drew attention to the ongoing opening of the communications industry to competition and to expected tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 1.08 billion in the first six months of 2004 to approximately NIS 2.21 billion during the period of report, mainly as a result of the effect of the first-time consolidation implemented during 2004. In addition, the segment's revenues increased as a result of an increase of approximately 112,000 in the net number of customers during the first half of 2005, the increase in revenues from sales of terminal equipment to customers and from the sale of repair service packages. Amendment of the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1 2005 slowed the upward trend in the segment's revenues. In partial compensation for the reduction of those tariffs, Pelephone increased the outgoing call tariff for some of its customers.

Revenues from the international communications and internet services segment increased from approximately NIS 401 million in the first six months of 2004 to approximately NIS 403 million during the period of report. The stability of revenues compared with revenues in the corresponding period derives from an increase in the number of ADSL customers, growth in international call routing traffic and growth in revenues from data services. The increase was offset mainly by a decrease in traffic and outgoing call tariffs, and a decrease in internet access service tariffs, due to increased competition in this segment resulting from the entry of additional carriers.

Revenues of approximately NIS 585 million from the multi-channel television segment were included in the Group's revenues for the first six months of 2005, due to the consolidation of DBS during the course of 2004. There has been an increase in revenues in this segment compared with the corresponding period as a result of the net increase of approximately 26,000 subscribers during the first half of 2005, and an increase in average revenue per subscriber.

C. General and Operating Expenses

The Group's general and operating expenses for the first six months of 2005 amounted to approximately NIS 3.51 billion compared with approximately NIS 2.22 billion during the corresponding period in the prior year. Approximately NIS 1.2 billion derives from first-time consolidation.

In the fixed-line domestic communications segment, general and operating expenses decreased from approximately NIS 1,140 million in the first half of 2004 to approximately NIS 1,129 million during the period of report. The decrease derives mainly from a reduction in the costs of material consumption, which was partly set off by an increase in the costs of building maintenance.

In the cellular segment, general and operating expenses increased from approximately NIS 804 million in the first six months of 2004 to approximately NIS 1,655 million during the period of report derived 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.

In the international communications and internet services segment, there was an increase in general and operating expenses from approximately NIS 271 million in the first six months of 2004 to approximately NIS 307 million during the period of report, 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.

General and operating expenses of approximately NIS 476 million from the multi-channel television segment were included in the Group's expenses for the first six months of 2005 due to the consolidation of DBS during 2004.

D. <u>Depreciation</u>

The Group's depreciation expenses increased from approximately NIS 939 million in the first six months of 2004 to approximately NIS 1,161 million during the period of report, resulting from the first-time consolidation in respect of which depreciation expenses increased by approximately NIS 275 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.

E. <u>Royalties to the Government of Israel</u>

The Group's royalties expense amounted to approximately NIS 130 million compared with NIS 96 million during the corresponding period in the prior year. The source of the increase is the first-time consolidation referred to above.

F. <u>Operating Income</u>

The Group's operating income in the first half of 2005 amounted to approximately NIS 703 million, compared with NIS 762 million during the corresponding period in the prior year, a decrease of approximately NIS 59 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 reduced due to the first-time consolidation of DBS's financial results as described above.

G. <u>Financing Expenses</u>

The Group's net financing expenses for the first six months of 2005 amounted to approximately NIS 165 million compared with approximately NIS 69 million during the corresponding period in the prior year. The source of approximately NIS 108 million of the expenses is the first-time consolidation. Group finance expenses are influenced by changes in interest rates, exchange rates and the Index.

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

In the cellular segment, financing expenses were reduced, *inter alia*, by recycling loans at lower interest rates and as a result of lower rates of inflation than in the corresponding period in the prior year.

Financing expenses of approximately NIS 95 million from the multi-channel television segment, were included in the Group's expenses for the first six months of 2005 due to the consolidation of DBS during 2004.

H. Other Income (Expenses)

Income amounting to approximately NIS 153 million was recorded in the Group's Other Income (Expenses) item, compared with expenses of approximately NIS 23 million during the corresponding period in the prior year. Most of the expense in the corresponding period was an increase in the provision for early retirement. The income recorded in the period of report derives mainly from capital gains of approximately NIS 107 million and a reduction in the provision for early retirement in the sum of approximately NIS 83 million (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 in the first half of 2005 amounted to approximately NIS 11 million compared with losses of approximately NIS 129 million recorded during the corresponding period in the prior year. Most of the decrease in the period of report derives from the transfer of DBS to a consolidated company towards the end of the first half of the previous year, and the results of its operations are presented in the financial statements on a consolidated basis, rather than by the equity method (see Note 4 to the financial statements).

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

## 3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities during the first half of 2005 amounted to approximately NIS 1,304 million, compared with approximately NIS 1,468 million during the corresponding period in the prior year. Eliminating an increase of approximately NIS 233 million deriving from first-time consolidation, cash flows from operating activities decreased by approximately NIS 397 million. In the fixed-line domestic communications and cellular segments, the reduction in cash flow was mainly due to changes in the assets and liabilities items. In addition, operating income in the fixed-line domestic communications segment also decreased, also contributing to the decrease in cash flows from operating activities.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the period of report included, *inter alia*, approximately NIS 984 million in the development of communications infrastructure and approximately NIS 190 million in short-term investments.

During the period, the Group repaid approximately NIS 1,173 in debts, of which approximately NIS 1,053 million was on account of long-term loans and approximately NIS 120 million was on account of debentures.

The Group raised new debt in a total amount of approximately NIS 1,656 million by an issuance of debentures and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 96 million. The average monthly long-term liabilities for the period was approximately NIS 8,558 million.

Working capital as at June 30, 2005, is positive and amounted to approximately NIS 1,986 million, compared with positive working capital of approximately NIS 577 million on June 30, 2004. The increase derives mainly from an improvement in working capital in the multi-channel television segment, in the amount of approximately NIS 1,331, as a result of a raising of long-term debt and payment of short-term loans, and from improvement in the working capital of Pelephone and its first-time full consolidation which increased working capital by approximately NIS 572 million. Conversely, there was a reduction of approximately NIS 647 million in working capital in the fixed-line domestic communications segment.

## 4. Comparison of the results of the second 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 quarter.

| | For the three-month period ended June 30 | |
|---|---|---|
| **Segment** | **2005** | **2004** |
| | **NIS Millions** | **NIS Millions** |
| Domestic communications | 206 | 255 |
| Cellular | 133 | 73 |
| International communications | 22 | 32 |
| Multi-channel television | (25) | - |
| Sites | 1 | 3 |

Revenue during the second quarter of 2005 increased by approximately NIS 715 million compared with the corresponding quarter in the prior year. An increase of approximately NIS 809 million derives from the effect of the first-time consolidation. Eliminating the effect of the first-time consolidation, there has been a reduction in the total revenues of the Group. General and operating expenses increased by approximately NIS 609 million compared with the corresponding quarter in the prior year. This increase is derived mainly from the first-time consolidation. Financing expenses during the second quarter of 2005 increased by approximately NIS 72 million compared with the corresponding quarter in the prior year. This increase is derived mainly from 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 half-yearly results. The changes described above in the statements of operations brought about a net profit of approximately NIS 164 million in the second quarter, compared with a net profit of approximately NIS 106 million in the corresponding quarter of the prior year.

## 5. Group involvement in the community and donations

During the period of the report, 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 report, the Company donated NIS 231,000 and overall throughout the campaign, a total of NIS 2,792,000.

## 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 June 30, 2005, is not significantly different from the report as at December 31, 2004.

C. The report on linkage bases as at June 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 June 30, 2005, amounted to approximately NIS 2.8 billion in the Group. As a result of forward currency transactions, the net balance of foreign currency liabilities not hedged as aforesaid as at June 30, 2005, amounts to approximately NIS 409 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at June 30, 2005, amount to approximately NIS 4.3 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 looking into the matter, including methods of solving the problem of confidentiality, and shall provide its recommendations for the discussion and approval of the Board.

**c. Sale of the Controlling Share**

On May 10, 2005, a notice was received from the Government Companies Authority to the effect that Ap. Sab. Ar. Holdings Ltd. had been chosen as the "preferred bidder" in the process of sale of the controlling share of the Company. Upon completion of the transaction and grant of consent and of the control of the Company to the preferred bidder in accordance with the Communications Law and the Telecommunications Order, the Company is expected to be released from certain limitations imposed upon it as a company controlled by the State of Israel, including cancellation and/or change of part of the provisions of its Articles of Association, which are similar to several provisions of the Government Companies Law, 5735-1975.

**d. Directors with Accounting and Financial Skills**

Current serving directors with accounting and financial skills are: Yigal Cohen Orgad (external director) and Hava Shechter.

**e. Chairman of the Board**

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

| | |
|---|---|
| **Hava Shechter** | **Amnon Dick** |
| **(Chairperson of the approval meeting)** | **CEO** |

# "BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

## CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## JUNE 30, 2005

**Interim Consolidated Financial Statements as at June 30, 2004**

## Contents

**Somekh Chaikin**
216 Jaffa Road
PO Box 212, Jerusalem 91001
Israel

Telephone 972 2 531 2000
Fax 972 2 531 2044
Internet www.kpmg.co.il

**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 June 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 June 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 six-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 June 30, 2005, constitute approximately 37% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 58% of the total revenues included in the condensed interim consolidated statement of operations for the six-month period then ended and approximately 57% 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 66 million as at June 30, 2005, and the Company's share in the losses in respect thereof amount to approximately NIS 11 million and approximately NIS 8 million for the six 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.

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.

**Somekh Chaikin**
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Israel

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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 investee companies, as described in Note 6A.

4. The financial position of a consolidated company including:

   a. Restrictions imposed by the Ministry of Communications and the Antitrust Commissioner on the Company in connection with additional cash transfers to the consolidated company.

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

As mentioned in Note 4, the continuation of the operations of the consolidated company is dependent upon the continued receipt of additional loans from shareholders, including loans from the Company and loans from additional lenders in accordance with the consolidated company’s work plan.

Somekh Chaikin
Certified Public Accountants (Isr.)

August 2, 2005

## Condensed Interim Consolidated Balance Sheets as at

### Reported amounts

| | June 30 2005 (Unaudited) | June 30 2004 (Unaudited) | December 31 2004 (Audited) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| **Current assets** | | | |
| Cash and cash equivalents | **2,119,303** | 3,199,933 | 1,457,107 |
| Short-term investments | **1,504,507** | 1,200,490 | 1,287,809 |
| Trade receivables | **2,076,741** | 1,743,501 | 2,115,070 |
| Other receivables and debit balances | **377,719** | 374,345 | 416,113 |
| Inventory | **285,544** | 143,027 | 314,549 |
| | **6,363,814** | 6,661,296 | 5,590,648 |
| **Materials and spare parts** | **142,092** | 150,736 | 130,922 |
| **Broadcasting rights, net** | **159,614** | 122,980 | 140,496 |
| **Investments and long-term receivables** | | | |
| Investments, deposits and debit balances | **924,052** | 738,708 | 872,575 |
| Investments in investee companies | **65,575** | 60,502 | 70,308 |
| | **989,627** | 799,210 | 942,883 |
| **Fixed assets** | | | |
| Cost | **35,030,011** | 31,039,413 | 34,311,281 |
| Less– accumulated depreciation | **24,695,498** | 21,656,097 | 23,570,947 |
| | **10,334,513** | 9,383,316 | 10,740,334 |
| **Other assets** | | | |
| Goodwill | **1,746,099** | 802,746 | 1,792,658 |
| Deferred charges and other assets | **378,479** | 213,907 | 387,904 |
| Deferred taxes | **407,882** | 469,469 | 446,136 |
| | **2,532,460** | 1,486,122 | 2,626,698 |
| | **20,522,120** | 18,603,660 | 20,171,981 |

| | June 30 2005 (Unaudited) | June 30 2004 (Unaudited) | December 31 2004 (Audited) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| **Current liabilities** | | | |
| Bank credit | **89,151** | 1,344,781 | 88,102 |
| Current maturities of: | | | |
| Long-term bank loans | **701,102** | 1,072,694 | 1,304,916 |
| Debentures | **307,650** | 175,612 | 240,481 |
| Trade payables | **1,262,678** | 1,362,487 | 1,675,569 |
| Employee severance benefits | **625,311** | 658,910 | 592,474 |
| Other current liabilities | **1,391,540** | 1,470,104 | 1,402,140 |
| | **4,377,432** | 6,084,588 | 5,303,682 |
| **Long-term liabilities** | | | |
| Long-term loans | **2,915,511** | 1,177,197 | 2,860,934 |
| Debentures | **4,756,884** | 3,530,796 | 3,824,539 |
| Employee severance benefits | **532,099** | 659,263 | 680,096 |
| Other long-term liabilities | **30,417** | 49,200 | 47,375 |
| Loans extended by the minority in a consolidated company: | | | |
| Loans | **1,085,140** | 1,048,637 | 1,057,988 |
| Less – minority share in deficit of a consolidated company | **(1,085,140)** | (1,048,637) | (1,057,988) |
| | **8,234,911** | 5,416,456 | 7,412,944 |
| **Minority rights** | **–** | (16,549) | (10,412) |
| **Contingent liabilities (Note 6)** | | | |
| **Shareholders' equity** | **7,909,777** | 7,119,165 | 7,465,767 |
| | **20,522,120** | 18,603,660 | 20,171,981 |

Hava Shechter
(Chairperson of the approval meeting)

Amnon Dick
Chief Executive Officer

Ron Eilon
Chief Financial Officer

Date of approval of the financial statements: August 2, 2005.

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

## Condensed Interim Consolidated Statements of Operations

### Reported amounts

| | For the six–month period ended June 30 | | For the three–month period ended June 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 8)** | **5,500,498** | 4,020,781 | **2,727,375** | 2,011,560 | 9,269,804 |
| **Costs and expenses** | | | | | |
| General and operating expenses (Note 9) | **3,505,652** | 2,223,980 | **1,741,801** | 1,133,168 | 5,565,090 |
| Depreciation | **1,161,317** | 938,789 | **583,810** | 466,997 | 2,092,475 |
| Royalties to the Government of Israel | **130,171** | 96,061 | **64,619** | 48,689 | 220,691 |
| | **4,797,140** | 3,258,830 | **2,390,230** | 1,648,854 | 7,878,256 |
| Operating income | **703,358** | 761,951 | **337,145** | 362,706 | 1,391,548 |
| **Financing expenses, net** | **(165,079)** | (68,747) | **(110,203)** | (37,998) | (217,529) |
| Earnings after financing expenses | **538,279** | 693,204 | **226,942** | 324,708 | 1,174,019 |
| **Other income (expenses), net (Note 10)** | **152,742** | (23,001) | **65,128** | 7,451 | 79,680 |
| Earnings before income tax | **691,021** | 670,203 | **292,070** | 332,159 | 1,253,699 |
| **Income tax** | **(259,823)** | (266,778) | **(126,953)** | (161,464) | (497,485) |
| Earnings after income tax | **431,198** | 403,425 | **165,117** | 170,695 | 756,214 |
| **Equity in losses of affiliates** | **(11,167)** | (129,330) | **(7,846)** | (64,446) | (134,773) |
| **Minority share in losses (earnings) of subsidiaries** | **8,979** | 128 | **7,032** | 52 | (616) |
| Earnings before the cumulative effect of a change in accounting method | **429,010** | 274,223 | **164,303** | 106,301 | 620,825 |
| **Cumulative effect of a change in accounting method as at the beginning of the year*** | **15,000** | – | – | – | – |
| Net earnings | **444,010** | 274,223 | **164,303** | 106,301 | 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 | **0.165** | 0.105 | **0.063** | 0.041 | 0.238 |
| Cumulative effect of a change in accounting method | **0.005** | – | – | – | – |
| **Net earnings per share** | **0.170** | 0.105 | **0.063** | 0.041 | 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 | | |
| **Six months ended June 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) | **–** | **–** | **–** | **444,010** | **444,010** |
| Balance as at June 30, 2005 (unaudited) | **6,309,133** | **1,623,423** | **37,775** | **(60,554)** | **7,909,777** |
| **Six months ended June 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) | – | – | – | 274,223 | 274,223 |
| Balance as at June 30, 2004 (unaudited) | 6,309,133 | 1,623,423 | 37,775 | (851,166) | 7,119,165 |
| **Three months ended June 30, 2005** | | | | | |
| Balance as at April 1, 2005 (unaudited) | **6,309,133** | **1,623,423** | **37,775** | **(224,857)** | **7,745,474** |
| Net earnings (unaudited) | **–** | **–** | **–** | **164,303** | **164,303** |
| Balance as at June 30, 2005 (unaudited) | **6,309,133** | **1,623,423** | **37,775** | **(60,554)** | **7,909,777** |
| **Three months ended June 30, 2004** | | | | | |
| Balance as at April 1, 2004 (unaudited) | 6,309,133 | 1,623,423 | 37,775 | (957,467) | 7,012,864 |
| Net earnings (unaudited) | – | – | – | 106,301 | 106,301 |
| Balance as at June 30, 2004 (unaudited) | 6,309,133 | 1,623,423 | 37,775 | (851,166) | 7,119,165 |
| **Year ended December 31, 2004** | | | | | |
| Balance as at December 31, 2003 (audited) | 6,309,133 | 1,623,423 | 37,775 | (1,125,389) | 6,844,942 |
| Net earnings (audited) | – | – | – | 620,825 | 620,825 |
| **Balance as at December 31, 2004 (audited)** | 6,309,133 | 1,623,423 | 37,775 | (504,564) | 7,465,767 |

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

## Condensed Interim Consolidated Statements of Cash Flows

### Reported amounts

| | For the six-month period ended June 30 | | For the three-month period ended June 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 | **444,010** | 274,223 | **164,303** | 106,301 | 620,825 |
| Adjustments to reconcile net earnings to net cash flows from operating activities (see A below) | **859,607** | 1,194,203 | **511,615** | 604,235 | 2,229,157 |
| Net cash generated by operating activities | **1,303,617** | 1,468,426 | **675,918** | 710,536 | 2,849,982 |
| **Cash flows from investing activities** | | | | | |
| Investment in fixed assets | **(983,580)** | (677,703) | **(508,072)** | (280,460) | (1,650,557) |
| Proceeds from disposal of fixed assets and sale of operations | **125,540** | 42,663 | **112,972** | 19,957 | 131,576 |
| Investment in long-term deposits and investments | **(6,982)** | (28,090) | **(6,982)** | (11,917) | (42,064) |
| Realization of long-term deposits and investments | **8,609** | 35,922 | **2,291** | 20,478 | 18,094 |
| Decrease (increase) in short-term investments, net | **(190,036)** | 182,192 | **85,053** | (77,975) | 135,602 |
| Decrease (increase) in materials and spare parts | **(33,816)** | (46,401) | **2,119** | 2,881 | 625 |
| Acquisition of companies consolidated for the first time (see C below) | – | – | – | – | (246,935) |
| Investment in investee companies | **(5,746)** | (108,129) | **(3,118)** | (61,221) | (142,753) |
| Investment in other assets | **(39,442)** | (70,424) | **(15,682)** | (24,762) | (130,700) |
| Net cash used in investing activities | **(1,125,453)** | (669,970) | **(331,419)** | (413,019) | (1,927,112) |
| **Cash flows from financing activities** | | | | | |
| Issue of debentures (after deduction of issue expenses) | **1,238,236** | 1,320,294 | **425,941** | 1,005,294 | 1,528,092 |
| Repayment of other debentures | **(120,307)** | (544,281) | **(28,704)** | (28,246) | (601,481) |
| Receipt of long-term loans | **417,500** | 139,500 | **303,000** | 67,474 | 314,900 |
| Repayment of long-term loans | **(1,052,446)** | (371,226) | **(460,896)** | (238,264) | (2,605,012) |
| Receipt (repayment) of short-term bank credit, net | **1,049** | (97,160) | **(14,410)** | (22,085) | (56,612) |
| Net cash generated by (used in) financing activities | **484,032** | 447,127 | **224,931** | 784,173 | (1,420,113) |
| **Increase (decrease) in cash and cash equivalents** | **662,196** | 1,245,583 | **569,430** | 1,081,690 | (497,243) |
| **Balance of cash and cash equivalents at the beginning of the period** | **1,457,107** | 1,954,350 | **1,549,873** | 2,118,243 | 1,954,350 |
| **Balance of cash and cash equivalents at the end of the period** | **2,119,303** | 3,199,933 | **2,119,303** | 3,199,933 | 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 six-month period ended June 30 | | For the three-month period ended June 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 | **1,161,317** | 938,789 | **583,810** | 466,997 | 2,092,475 |
| Deferred taxes | **73,750** | 1,804 | **32,891** | 64,818 | 219,975 |
| Company's equity in losses of affiliated companies | **11,167** | 129,330 | **7,846** | 64,446 | 134,773 |
| Minority share in earnings (losses) of a subsidiary | **(8,979)** | (128) | **(7,032)** | (52) | 616 |
| Decrease in employee severance benefits, net | **(115,160)** | (59,784) | **(89,874)** | (9,067) | (110,334) |
| Loss (gain) on disposal of fixed assets | **(2,749)** | 396 | **(1,019)** | 316 | (7,338) |
| Provision for decrease in value of investments | **4,700** | – | **4,700** | – | 26,000 |
| Gain from sale of operations | **(103,869)** | – | **(2,009)** | – | (35,033) |
| Erosion (appreciation) and interest on long-term deposits and investments | **13,146** | (19,658) | **(8,693)** | (12,399) | 31,199 |
| Erosion (appreciation) of short-term investments, net | **(26,662)** | 10,145 | **(12,286)** | (6,540) | (10,584) |
| Appreciation (erosion) of long-term liabilities: | | | | | |
| Debentures | **(118,415)** | 1,739 | **(34,024)** | 2,241 | 115,674 |
| Long-term loans and other liabilities | **76,058** | 44,925 | **50,569** | 3,546 | (17,104) |
| Amortization of other assets and deferred expenses | **95,724** | 43,918 | **47,788** | 20,468 | 110,083 |
| Changes in asset and liability items: | | | | | |
| Increase in broadcasting rights | **(19,118)** | – | **(8,997)** | – | (17,516) |
| Decrease (increase) in trade receivables | **(14,518)** | 2,600 | **(6,248)** | 101,905 | 52,827 |
| Decrease (increase) in other receivables and debit balances | **(23,953)** | 82,129 | **5,291** | (1,336) | (8,223) |
| Decrease (increase) in inventory | **19,103** | (62,752) | **13,363** | (48,457) | (122,824) |
| Decrease in trade payables | **(169,270)** | (115,863) | **(26,498)** | (168,985) | (102,466) |
| Increase (decrease) in other current liabilities | **24,318** | 211,697 | **(38,317)** | 129,346 | (126,652) |
| Increase (decrease) in deferred revenues | **(16,983)** | (15,084) | **354** | (3,012) | 3,609 |
| | **859,607** | 1,194,203 | **511,615** | 604,235 | 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 six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **B– Non-cash transactions** | | | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit | **72,981** | 58,299 | **72,981** | 58,299 | 102,687 |
| Sale of fixed assets on credit | | – | | – | 1,196 |
| **C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company** | | | | | |
| Working capital (excluding cash and cash equivalents) | – | 1,795,696 | – | 1,795,696 | 2,057,632 |
| Fixed assets | – | (1,204,051) | – | (1,204,051) | (2,967,819) |
| Long-term liabilities | – | 20,862 | – | 20,862 | 2,322,740 |
| Minority loans to a subsidiary | – | 1,048,637 | – | 1,048,637 | 1,048,637 |
| Less minority share in the deficit | – | (1,048,637) | – | (1,048,637) | (1,048,637) |
| Minority rights | – | (16,549) | – | (16,549) | (16,549) |
| Investment in an affiliate | – | 180,553 | – | 180,553 | 178,339 |
| Goodwill | – | (776,511) | – | (776,511) | (1,821,278) |
| | – | – | – | – | (246,935) |

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

**Notes to the Financial Statements as at June 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 subsidiaries as at December 31, 2004, and for the year then ended, and the accompanying notes thereto (hereinafter – the Annual Reports).

**C.** The Company presents in the notes to the interim financial statements only those significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of cellular telephone services, international communication services, domestic communication services, multi-channel television services, the opening of these markets to competition, and decisions of the Ministerial Committee on Privatization relating to the sale of the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2004. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:

(1) On April 10, 2005, a copy of a letter of the Director General of the Ministry of Communications dated April 6, 2005, was forwarded to the Company. The letter is addressed to the Director of the Government Companies Authority and contains clarifications for the participants in the privatization 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.

**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.

(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 apply retroactively also for the trial period. As at the date of publication of these financial statements, dialing directions have been opened for one licensee, and the Company is in contact with other holders of the trial licenses for their 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.

(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 2005 Law (Legislative Amendments), 5765-2004 was passed by the Knesset. The law includes, among other things, an amendment of the Communications Law (Telecommunications and Broadcasting), 5742-1982, 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, 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 April 20, 2005, the Ministry of Communications sent to the licensees a draft numbering plan which it is considering implementing and operating, for their remarks by May 18, 2005. The draft sets out milestones by which the licensee must have installed and operated all the means required for the application of number portability in its systems no later than January 31, 2006, will commence interconnect tests no later than February 1, 2006 and complete them no later than June 1, 2006, and will provide number portability to whoever requests it no later than August 1, 2006.

**Notes to the Financial Statements as at June 30, 2005**

**NOTE 1 – GENERAL (CONTD.)**

**C.** (5) **(contd.)**

On July 31, 2005, the Company submitted its position to the Ministry of Communications, according to which the timetables set for the implementation of the number portability plan, as outlined by the Ministry, are impossible to meet, and requested the establishment of a committee to re-examine the timetables and the options for implementation of the number portability plan and to submit a recommended program, including for changing the law.

The implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. 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. Even though the date for the implementation of number portability has been extended beyond the date originally proposed in the Bill (which was February 2006), and with which the Company commented that it believes it will be unable to comply, it will nevertheless be difficult for the Company to ready itself for number portability even by the date approved by the Committee (even if extended to the end of 2006). In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the ability of the Company and of the other companies in the Group to compete.

(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.

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 more time 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 comply with 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.

**NOTE 1 – GENERAL (CONTD.)**

**C.** (7) **(contd.)**

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 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 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 of 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 Government Companies Authority, the subject of which was amendment of 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 in 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 means even lower revenues than aforesaid, to the extent that the change in the calculation formula also results in a higher efficiency factor in the subsequent updates, which apply from June 2006 to the end of the arrangement period,.

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 includes the adjusted method of calculation.

**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 June 30, 2005 is NIS 13 million. No provision in respect of such a bonus has been recorded in the financial statements as the conditions for its grant have not yet been fulfilled.

**E.** (1) During the period of report, Bezeq Zahav Holdings Ltd. (hereinafter – Bezeq Zahav) 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 Zahav as repayment of a loan which the Company extended to Bezeq Zahav for purchase of those debentures (Series 4). Subsequent to the sale of the debentures, Bezeq Zahav 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.

**NOTE 1 – GENERAL (CONTD.)**

**E. (contd.)**

(2) On April 4, 2005, the Company completed a private issuance to institutional investors, of 286,967,000 debentures (Series 5) of NIS 1 par value each. 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 February 27, 2005, Pelephone issued NIS 500 million debentures, bearing 4.4% interest, to institutional investors by way of a private placement. 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, in consideration of their face 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 will be repaid in twenty half-yearly payments of the principal and interest commencing January 2006. 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.Sav.Ar Holdings Ltd. (" the Preferred Bidder") as the 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").

According to the notice of the Director General of the Government Companies Authority, the Preferred Bidder offered NIS 4,237,000,000 for the State's Holdings (" the Offered Price") in its final offer.

Transfer of the State's Holdings to the Preferred Bidder requires approvals according to any law, including the approval of the Prime Minister and the Minister of Communications pursuant to the Communications Law (Telecommunications and Broadcasting), 5724-1982 ("the Communications Law") and the Telecommunications Order (Determination of an essential service provided by Bezeq, The Israel Telecommunication Corp. Ltd.), 5757-1997 ("the Telecommunications Order"), and the consent of the Antitrust Commissioner pursuant to the Restraint of Trade Law, 5758-1998. After receipt of the requisite approvals, the State transferred the State's Holdings to the Preferred Bidder against payment of the Offered Price plus Accountant General's interest from the date of submission of the bids to the date of transfer of the State's Holdings to the Preferred Bidder.

It should be noted that the consent of the Antitrust Commissioner for the transaction was given on May 17, 2005.

Following the "industrial espionage" affair (see also Note 6A(19) below) and disputes that arose between the State and the Preferred Bidder concerning the effects of the affair on the Bezeq Group, on July 7, 2005, the parties reached agreement regarding various demands made by the Preferred Bidder as a condition for closing the transaction. According to a notice of the Government Companies Authority, the agreement will affect the exercise price of the options which the Preferred Bidder received, insofar as there is a connection, and as a result of the above affair and the accrual of interest on the price of the transaction until its closing.

With the closing of the transaction and grant of control of the Company to the Preferred Bidder in accordance with the Communications Law and the Telecommunications Order, the Company will be released from certain restrictions imposed upon it as a company controlled by the State of Israel, including 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.

## 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.

### B. INITIAL APPLICATION OF ACCOUNTING STANDARDS

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

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.

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

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

| | Consumer price index | Exchange rate of the US dollar | Exchange rate of the euro |
|---|---|---|---|
| | % | % | % |
| For the six-month period ended: | | | |
| June 30, 2005 | **0.497** | **6.175** | **(5.955)** |
| June 30, 2004 | 1.511 | (0.685) | (1.257) |
| For the three-month period ended: | | | |
| June 30, 2005 | **1.100** | **4.884** | **(2.159)** |
| June 30, 2004 | 1.408 | 2.695 | (1.218) |
| 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 six-month period ended June 30, 2005, amount to approximately NIS 144 million. As a result of these losses, the capital deficit and working capital deficit as at June 30, 2005 amount to approximately NIS 3,343 million and NIS 468 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,535 million (nominal). The Company's equity in the accumulated losses of DBS from the date of investment is approximately NIS 1,400 million, of which approximately NIS 130 million was recorded during the period of report. (DBS's losses for the period, net of new loans given by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 62 million.

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 (increasing the Company's holdings in DBS to more than 50%) by the Antitrust Commissioner ("the Commissioner"), (in which, *inter alia*, the Commissioner restricted the funds that could be injected by the Company into DBS so that for a period of nine months from the date of approval of the merger, they would not exceed the proportional part of the Company in the shares of DBS while the other part would be injected by other shareholders in DBS and by institutional investors), the Company would delay, at this stage, 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 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. Concurrently, the cable companies appealed the decision of the Commissioner as aforementioned, in which they request that the Company not be permitted to increase its holdings in DBS. Applications for dismissal *in limine* of this appeal, which were filed by the Company and DBS, were dismissed on July 25, 2005. The cable companies also filed a request to join the appeals filed by the Company and DBS and their request was denied on July 25, 2005. A hearing of the appeals of the Company and DBS has been scheduled for September 22, 2005. On the matter of the Commissioner's letter dated 25 July, 2005 concerning the loan agreements signed by DBS with three institutional entities, see below.

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 (rather than NIS 440 million).

b. With regard to the NIS 195 million of the additional funding already transferred by the Company to DBS, the Minister does not intend to take any 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 82.25 million).
   (2) The share of the other shareholders in DBS and of the banks or institutional bodies in the transfer of the balance will be not less than 45% (i.e. a minimum of NIS 69.75 million).

## NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

### A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (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 need for time to implement the directive, she agreed, in a letter dated February 14, 2005, to allow staggered implementation of the former Minister's decision in the following manner:

a. The Company will be able to inject up to 75% of the maximum amount (NIS 64 million) by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it 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 to the end of 2005, provided that the proportions of the transfer are maintained as set out in the former Minister's letter.

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

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 for 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. Subsequently, on May 10, 2005, the Company filed a petition in the High Court of Justice on this matter. It should be is noted that DBS also filed a similar petition, to which the cable companies were joined as respondents, in the High Court of Justice on the same matter. The petition is scheduled for hearing on October 11, 2005.

**Notes to the Financial Statements as at June 30, 2005**

## NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

The petition raises basic questions which are far from simple, both factually and legally, and the Company, relying on its legal advisers, is unable, at this stage, 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(18).

The terms of the long-term loans which DBS received from certain banking corporations (hereinafter "the Banks"), whose balance as at June 30, 2005, is NIS 1,275 million, 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 June 30, 2005, DBS is in compliance with those Conditions.

In March 2005, DBS signed an agreement with an institutional body whereby that body will extend a loan of NIS 15 million to DBS on three dates. Of the aforementioned amount, DBS has received:

(1) NIS 7.5 million on the date of signing.
(2) NIS 3.75 million subsequent to the balance sheet date, in July 2005.
(3) An additional NIS 3.75 million is due on October 1, 2005.

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

In April 2005, DBS signed agreements with two additional institutional bodies for receipt of NIS 20 million and NIS 15 million in loans, in one payment on the same terms (including an option for additional loans in the same amounts). These amounts were transferred to the company in May 2005 Each of the three institutional entities has an option to extend an additional loan in the same amount as its above loan, provided that the amounts of the loans are required according to DBS's business plan. In June 2005, one of the entities exercised the option and transferred an additional NIS 20 million into DBS. It is clarified that the Company's undertaking under the signed loan agreements applies also to this additional amount. This additional loan (as well as the other loans extended to DBS by institutional entities as described above), is not in compliance with the terms and restrictions imposed by the Antitrust Commissioner and 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.

## NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

On July 25, 2005, a letter was sent to the Company from the Antitrust Authority, in which a claim is made against the Company that in connection with the loan agreements which DBS signed with three institutional entities as described above and which were forwarded to the Commissioner for review, at his request, that the Company provided a guarantee for part of the loan amounts and therefore those agreements are not in keeping with the terms of the merger laid down by the Commissioner. The letter also alleges that a further transfer of funds by the Company to DBS might already constitute abuse of its monopoly status. The Company's position is that in view of its decision to delay exercise of its option so that its holdings in DBS will remain at approximately 49.8%, the restrictive conditions imposed by the Commissioner have not come into force and are not binding upon it. In its reply to the above letter from the Antitrust Authority, the Company dismissed the allegations of the Commissioner, and reminded him that it had maintained contact with representatives of the Commissioner so that the loan agreements with the institutional investors would conform to a possible outline indicated by the Commissioner, despite the fact that it has not yet exercised the options which are the subject of the merger application it filed, and therefore, as stated, the restrictive conditions are not binding. The Company also noted in its reply that the matter is pending in an appeal to the Antitrust Tribunal. The Company dismissed the allegations of the Commissioner that the loan agreements contravene the provisions of the Restrictive Trade Practices Law and stated that it sees neither cause nor justification for the Commissioner to exercise his authority in this context.

As at June 30, 2005, the Company had transferred NIS 256 million of the Additional Injection.

At a meeting of the shareholders of DBS on January 16, 2005, the representatives of two other shareholders announced that they intend to recommend to the appropriate bodies of their companies that they participate in further transfers of NIS 20 million and NIS 10 million, respectively, to DBS. These recommendations 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 continuing receipt of additional loans from the shareholders, including loans from the Company, as well as loans from other lenders in accordance with DBS's work plan.

In the opinion of the Management of DBS and of the Company, there is a good chance that the financial resources that DBS will need in the coming year can be arranged, *inter alia* in view of the resolution of the Board of Directors of the Company, as noted above, in order to continue investment in DBS according to the work plan, together with other shareholders and financial entities.

### B. 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.

## 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 6, 2005, was canceled on April 13, 2005, after an exchange of letters between the Company, the employees representatives and the Government Companies Authority, the main points of which were:

   "(1) It is possible that after sale of the State's holdings in the Company, the Company will request negotiations with the employees' organization in accordance with Section 4A of the Special Collective Agreement (Amendment) dated March 18, 2004, which states that 'Immediately after signing this agreement, the parties will 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, the above will not change the existing agreement. Furthermore, the aforementioned clarifications do not have an effect on the financial statements of the Company. To the best of the Company's knowledge, the exchange of letters was presented to the participants in the proceeding for the sale of the State's holdings in the Company.

## NOTE 6 – CONTINGENT LIABILITIES

### A. CLAIMS AND CONTINGENT LIABILITIES

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

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

(2) Further to Note 19A(2)a. to the financial statements as at December 31, 2004, concerning the investigation of the Antitrust Commissioner into suspected restrictive arrangements relating to the supply of large exchanges (public switching) and following the dismissal of the Company's petition to direct the Antitrust Authority to allow the Company a hearing, to submit classified material and to refrain from issuing a determination according to Section 43 of the Antitrust Law, the Company filed a written argument as part of a hearing in the matter of the Antitrust Authority's intention to issue such a determination. Discussions between the Company and the Antitrust Authority in an attempt to arrive at an agreed Order (which would prevent issue of the determination), have not been successful.

(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 is supposed to give notice of the position of the claimants on the matter.

(4) Further to Note 19A(5) to the financial statements as at December 31, 2004, concerning a number of claims in the matter of recognition of various salary components as pension components and recognition of various components 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, 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.

(5) 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.

## NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(6) 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 n the financial statements in respect of this claim.

b. On May 23, 2005, the Company received a claim for damages in respect of property damage and financial loss 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 losses, 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 split the reliefs so as to enable future claims for damages. The statement of defense on behalf of the Company and the other defendants has not yet been filed. At this early stage, the Company, based on the opinion of its legal advisers, is unable to estimate the chances of the outcome of the claims against it, and accordingly, no provision has been made in its financial statements in respect of this claim.

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.

## NOTE 6 – CONTINGENT LIABILITIES (C0NTD.)

### A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(7) 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 given 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.

(8) 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 264 retirees of the Company, for enforcement of the agreement from April 2001, whereby the employees are to 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 remained declaratory only. The case is scheduled for hearing on December 15, 2005.

(9) 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 were 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.

(10) 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.

(11) Further to Note 19A(23) to the financial statements as at December 31, 2004, concerning a class action in which it is alleged that the Company's charges and calculations for Internet access in the "WOW Extra" and "WOW Summer 2004" campaigns constituted deception, fraud, unjust enrichment and overcharging, the Company's investigation revealed that the plaintiff was not overcharged and for official-technical reasons the charge was split into a charge and a credit. 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.

(12) 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, which amounts to approximately NIS 17 million.

## NOTE 6 – CONTINGENT LIABILITIES (C0NTD.)

### A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(12) (contd.)

The Company replied to the Ministry of Communications that it is adhering to 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.

(13) 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 decided not to include a provision in its interim financial statements in respect of the claim.

(14) 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 elapsed.

(15) 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 interministry 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 for grant of an order against the Government of Israel to give the 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.

(16) 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.

(17) 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.

## NOTE 6 – CONTINGENT LIABILITIES (C0NTD.)

### A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(18) Further to Note 19C(2) to the financial statements as at December 31, 2004, concerning a bank guarantee 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 dollar 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 of 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.

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 CEO of the Ministry of Communications notified the Company, and therefore no provision has been made in the financial statements. An appeal against the decision has been delivered to the Minister of Communications and as a result thereof, implementation of the decision has meantime been frozen. An appeal has been filed with the Minister of Communications against the decision and as a result, the foreclosure is suspended for now. 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, is scheduled for October 11, 2005.

(19) **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).

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 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.

## NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(19) **The "industrial espionage" affair (contd.)**

In its response to the application, DBS rejected the allegations of HOT and stated that without waiving any of its allegations, 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 an order. In this way, the court in fact dismissed the applications of HOT for the appointment of a receiver and a temporary injunction of broader scope that 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 police investigation of the industrial espionage by computer (a Trojan horse program). After 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 its response to the news, Pelephone stated that its employees have no connection with obtaining information by unlawful means, that it and its employees were surprised by the news and they had cooperated with the police in clarifying the facts of the affair.

It should be noted that a number of senior employees of the Company were summonsed to the police to make statements regarding confidential 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 is studying the matter, as well as action regarding Company confidential material found on the premises of its competitors. With regard to the effects of this affair on the privatization of the Company, see Note 1F above.

### B. SECURITIES, LIENS AND GUARANTEES

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 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 giving 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 differentials) and the amount calculated according to a predetermined formula which takes into account the value of DBS to its shareholders at that time.

## NOTE 6 – CONTINGENT LIABILITIES (C0NTD.)

### 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 user 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 previous quarter and in this quarter most of the handsets were supplied to the AG.

### D. FUTURES TRANSACTIONS

**Forward Currency Transactions – Hedging Transactions**

**Consolidated**

| | Currency purchased | Currency payable | Final repayment date | Amounts receivable | Amounts payable |
|---|---|---|---|---|---|
| | | | | NIS millions | |
| **Currency exchange contracts at predetermined interest rates** | Euro | Index | October 2005 | 29 | 28 |
| **Forward contracts at** | Dollars | Shekel | September 2006 | 643 | 637 |
| **predetermined exchange rate** | Euro | Shekel | May 2006 | 1,608 | 1,686 |
| (excluding premium/discount) | CPI-linked NIS | Shekel | January 2006 | 515 | 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, 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 a new framework agreement replacing the previous one, in 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 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 is drafting its response to the Commissioner. As at the date of approval of the financial statements, the parties are acting in accordance with the previous framework agreement.

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

**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 for 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 by way of a private placement of 30% of the share capital of the Company and options to purchase an additional 10.66% of the share capital of the Company.

The undertaking to indemnify will be granted to officers who served ad/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 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 April 20, 2005, the Audit Committee and the Board of Directors of the Company resolved to insure and indemnify the officers of the Company as follows:

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

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

### C. BENEFITS FOR COMPANY OFFICERS (CONTD.)

(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 another 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 for making a commitment in advance to indemnify the officers of the Company who were serving in the Company at the time of making the commitment to indemnify, which will apply on the date of 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 indemnity 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.

The above resolutions were approved by the general meeting of the shareholders on May 16, 2005, and will be implemented on the date of closing the sale.

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 Company filed its response to the claim, rejecting the allegations of the plaintiff.

(3) On July 11, 2005, it was resolved to call a Special General Meeting of the shareholders of the Company on August 3, 2005, the agenda for which will be 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.

**Notes to the Financial Statements as at June 30, 2005**

## NOTE 8 – REVENUES FROM COMMUNICATION SERVICES

| | For the six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from communication services –** | | | | | |
| Fixed-line communications - traffic | **716,460** | 833,328 | **348,223** | 410,865 | 1,567,631 |
| Fixed fees | **1,267,564** | 1,230,016 | **643,194** | 616,883 | 2,501,250 |
| Cellular telephone | **1,823,987** | 1,050,893 | **896,623** | 533,541 | 2,699,876 |
| International communications and internet services | **380,755** | 379,052 | **192,189** | 188,710 | 771,290 |
| Multi-channel television | **576,136** | – | **292,002** | – | 529,838 |
| Installation and sale of equipment to subscribers | **557,740** | 326,479 | **275,705** | 159,373 | 825,390 |
| Miscellaneous | **70,314** | 37,547 | **19,244** | 21,026 | 89,448 |
| | **5,374,058** | 3,857,315 | **2,667,180** | 1,930,398 | 8,984,723 |
| Other revenues | **126,440** | 163,466 | **60,195** | 81,162 | 285,081 |
| | **5,500,498** | 4,020,781 | **2,727,375** | 2,011,560 | 9,269,804 |

## NOTE 9 – OPERATING AND GENERAL EXPENSES

| | For the six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and incidental expenses – | | | | | |
| Operations | **875,475** | 717,481 | **437,879** | 351,410* | 1,578,426 |
| General and administrative | **326,697** | 244,314 | **164,254** | 129,462* | 549,869 |
| Total salaries and related expenses | **1,202,172** | 961,795 | **602,133** | 480,872 | 2,128,295 |
| General expenses | **613,743** | 368,960 | **314,229** | 190,825 | 996,323 |
| Materials and spare parts | **499,155** | 271,444 | **242,609** | 132,877 | 643,013 |
| Consumption of content from satellite services | **202,251** | – | **102,053** | – | 200,469 |
| Cellular telephone expenses | **477,642** | 251,425 | **223,121** | 124,530 | 700,890 |
| Building maintenance | **169,805** | 153,176 | **82,998** | 84,399 | 352,430 |
| Services and maintenance by sub-contractors | **210,637** | 136,275 | **104,876** | 66,740 | 341,999 |
| International communications expenses | **130,121** | 103,491 | **66,094** | 57,721 | 228,936 |
| Vehicle maintenance expenses | **81,164** | 60,748 | **41,078** | 31,023 | 144,630 |
| Collection fees | **24,755** | 18,911 | **12,682** | 10,153 | 39,357 |
| | **3,611,445** | 2,326,225 | **1,791,873** | 1,179,140 | 5,776,342 |
| Less – salaries charged to investment in fixed assets | **105,793** | 102,245 | **50,072** | 45,972 | 211,252 |
| | **3,505,652** | 2,223,980 | **1,741,801** | 1,133,168 | 5,565,090 |

* Restated.

**Notes to the Financial Statements as at June 30, 2005**

## NOTE 10 – OTHER INCOME (EXPENSES), NET

| | For the six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Provision for claims for salary and pension components | **-** | (30,000) | **-** | - | 207,000 |
| Provision for employee severance benefits upon early retirement | **83,000** | - | **90,000** | - | (105,000) |
| Provision for impairment and other liabilities in respect of the value of investments in other companies | **(4,700)** | - | **(4,700)** | - | (26,000) |
| Compensation in respect of a settlement agreement | **14,483** | - | **-** | - | - |
| Amortization of goodwill | **(46,559)** | (364) | **(23,729)** | (364) | (35,135) |
| Capital gain from sale of operation (1) | **103,869** | - | **2,009** | - | 35,033 |
| Capital gains, net | **2,749** | (396) | **1,019** | (316) | 7,338 |
| Others | **(100)** | 7,759 | **79** | 8,131 | (3,556) |
| | **152,742** | (23,001) | **65,128** | 7,451 | 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.

## NOTE 11 – INCOME TAX

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 from 34% to 25% 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 June 30, 2005 are computed according to the old tax rates in effect prior to the above Amendment. The effect of the change on the consolidated financial statements is expected to be an increase of approximately NIS 45 million in the Company tax expenses on revenues in the statement of operations and a corresponding decrease in the deferred taxes included in the Company balance sheets and a corresponding effect of approximately NIS 40 million in the consolidated statements of operations and balance sheets.

## Notes to the Financial Statements as at June 30, 2005

## NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

### A. STATEMENTS OF OPERATIONS

| | For the six-month period ended June 30 | | For the three-month period ended June 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)** | **2,355,190** | 2,522,148 | **1,159,472** | 1,245,170 | 4,959,691 |
| **Costs and expenses** | | | | | |
| Operating and general expenses (Note 12C) | **1,129,235** | 1,139,849 | **567,231** | 585,646 | 2,347,448 |
| Depreciation | **700,478** | 756,346 | **351,083** | 375,651 | 1,495,909 |
| Royalties to the Government of Israel | **70,106** | 74,573 | **34,720** | 37,802 | 145,318 |
| | **1,899,819** | 1,970,768 | **953,034** | 999,099 | 3,988,675 |
| Operating income | **455,371** | 551,380 | **206,438** | 255,071 | 971,016 |
| **Financing expenses, net** | **(31,023)** | (31,234) | **(25,096)** | (17,368) | (93,216) |
| Earnings after financing expenses | **424,348** | 520,146 | **181,342** | 237,703 | 877,800 |
| **Other revenues (expenses), net** | **199,400** | 28,357 | **88,629** | 1,575 | 109,904 |
| Earnings before income tax | **623,748** | 491,789 | **269,971** | 239,278 | 987,704 |
| **Income tax** | **(198,688)** | (228,871) | **(95,642)** | (142,780) | (387,079) |
| Earnings after income tax | **425,060** | 262,918 | **174,329** | 96,498 | 600,625 |
| **Company's equity in earnings (losses) of investee companies** | **3,950** | 11,305 | **(10,026)** | 9,803 | 20,200 |
| Earnings before the cumulative effect of change in accounting method | **429,010** | 274,223 | **164,303** | 106,301 | 620,825 |
| **Cumulative effect of change in accounting method as at the beginning of the year*** | **15,000** | – | **–** | – | – |
| Net earnings | **444,010** | 274,223 | **164,303** | 106,301 | 620,825 |

* See Note 2B

## Notes to the Financial Statements as at June 30, 2005

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

### B. REVENUES FROM COMMUNICATION SERVICES

| | For the six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Fixed-line domestic communications - | | | | | |
| Traffic | **744,070** | 839,487 | **363,610** | 413,510 | 1,590,671 |
| Fixed fees | **1,190,425** | 1,169,069 | **604,531** | 583,715 | 2,354,700 |
| Total revenues from fixed-line communications | **1,934,495** | 2,008,556 | **968,141** | 997,225 | 3,945,371 |
| Cellular telephone | **185,466** | 219,268 | **92,806** | 112,201 | 414,740 |
| International communications | **53,978** | 66,015 | **25,459** | 31,131 | 126,856 |
| Installation and sale of equipment to subscribers and miscellaneous | **74,274** | 127,665 | **20,099** | 63,353 | 266,980 |
| | **2,248,213** | 2,421,504 | **1,106,505** | 1,203,910 | 4,753,947 |
| Other revenues | **106,977** | 100,644 | **52,967** | 50,260 | 205,744 |
| | **2,355,190** | 2,522,148 | **1,159,472** | 1,254,170 | 4,959,691 |

### C. OPERATING AND GENERAL EXPENSES

| | For the six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and related expenses – | | | | | |
| Operations | **552,371** | 562,908 | **274,904** | 272,185 | 1,122,381 |
| General and administrative | **136,773** | 135,955 | **68,133** | 77,982 | 271,310 |
| Total salaries and related expenses | **689,144** | 698,863 | **343,037** | 350,167 | 1,393,691 |
| General expenses | **154,034** | 157,493 | **80,274** | 79,176 | 341,977 |
| Materials and spare parts | **38,375** | 62,795 | **17,485** | 33,067 | 114,443 |
| Building maintenance | **153,088** | 140,392 | **74,862** | 78,355 | 315,074 |
| Services and maintenance by sub-contractors | **102,987** | 102,791 | **52,846** | 49,267 | 205,192 |
| International communications expenses | **9,875** | 9,340 | **4,800** | 5,030 | 27,105 |
| Vehicle maintenance expenses | **57,407** | 51,726 | **28,977** | 26,409 | 111,359 |
| Collection fees | **18,238** | 18,694 | **9,441** | 10,147 | 36,904 |
| | **1,223,148** | 1,242,094 | **611,722** | 631,618 | 2,545,745 |
| Less– salaries charged to investments in fixed assets | **93,913** | 102,245 | **44,491** | 45,972 | 198,297 |
| | **1,129,235** | 1,139,849 | **567,231** | 585,646 | 2,347,448 |

**Notes to the Financial Statements as at June 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 six-month period ended June 30, 2005 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Multi-channel television | Others | Adjustments | Consolidated |
| **Revenues** | | | | | | | |
| Revenues from external sources | 2,220,879 | 2,204,227 | 392,789 | 576,136 | 106,467 | – | 5,500,498 |
| Inter-segment revenues | 134,311 | 7,565 | 9,754 | 8,797 | 60,817 | (221,244) | – |
| Total revenues | 2,355,190 | 2,211,792 | 402,543 | 584,933 | 167,284 | (221,244) | 5,500,498 |
| **Segment results*** | 455,371 | 254,320 | 42,884 | (49,793) | 576 | – | 703,358 |

| | For the six-month period ended June 30, 2004 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Multi-channel television | Others | Adjustments | Consolidated |
| **Revenues** | | | | | | | |
| Revenues from external sources | 2,420,696 | 1,074,786 | 396,638 | – | 128,661 | – | 4,020,781 |
| Inter-segment revenues | 101,452 | 3,126 | 4,405 | – | 22,623 | (131,606) | – |
| Total revenues | 2,522,148 | 1,077,912 | 401,043 | – | 151,284 | (131,606) | 4,020,781 |
| **Segment results*** | 551,380 | 140,007 | 66,559 | – | 4,005 | – | 761,951 |

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

## Notes to the Financial Statements as at June 30, 2005

### NOTE 13 – BUSINESS SEGMENTS (CONTD.)

| | For the three-month period ended June 30, 2005 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Multi-channel television | Others | Adjustments | Consolidated |
| **Revenues** | | | | | | | |
| Revenues from external sources | 1,088,439 | 1,097,947 | 198,977 | 291,742 | 50,270 | – | 2,727,375 |
| Inter-segment revenues | 71,033 | 3,524 | 4,395 | 4,529 | 33,571 | (117,052) | – |
| Total revenues | 1,159,472 | 1,101,471 | 203,372 | 296,271 | 83,841 | (117,052) | 2,727,375 |
| **Segment results*** | 206,438 | 133,051 | 22,367 | (25,340) | 629 | – | 337,145 |

| | For the three-month period ended June 30, 2004 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed line communications | Cellular telephone | International communications and Internet services | Multi-channel television | Others | Adjustments | Consolidated |
| **Revenues** | | | | | | | |
| Revenues from external sources | 1,203,825 | 541,125 | 203,075 | – | 63,535 | – | 2,011,560 |
| Inter-segment revenues | 50,345 | 1,654 | 358 | – | 13,095 | (65,452) | – |
| Total revenues | 1,254,170 | 542,779 | 203,433 | – | 76,630 | (65,452) | 2,011,560 |
| **Segment results*** | 255,071 | 73,197 | 32,010 | – | 2,428 | – | 362,706 |

| | For the year ended December 31, 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 income (expenses), net, as stated in Note 10.

## 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

| | June 30 2005 | June 30 2004 | December 31 2004 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **1,632,512** | 1,325,899 | 1,413,049 |
| Long-term trade receivables | **321,600** | 232,998 | 278,778 |
| Investment in investee companies | **4,283** | 4,996 | 4,084 |
| Deferred income tax | **51,129** | 158,180 | 106,503 |
| Fixed assets, net | **3,061,145** | 2,931,469 | 3,093,675 |
| Other assets | **330,053** | 368,394 | 334,028 |
| | **5,400,722** | 5,021,936 | 5,230,117 |
| Current liabilities | **1,378,262** | 1,962,997 | 1,794,413 |
| Long-term liabilities | **1,750,652** | 1,050,458 | 1,305,674 |
| Shareholders' equity | **2,271,808** | 2,008,481 | 2,130,030 |
| | **5,400,722** | 5,021,936 | 5,230,117 |

**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 six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from Pelephone services, sales and services** | **2,211,792** | 2,155,823 | **1,101,471** | 1,085,559 | 4,412,344 |
| **Cost of Pelephone services, sales and services** | **1,686,130** | 1,572,966* | **826,979** | 788,345* | 3,258,877* |
| Gross profit | **525,662** | 582,857 | **274,492** | 297,214 | 1,153,467 |
| **Sales and marketing expenses** | **215,172** | 236, 853* | **110,192** | 120, 612* | 470,408* |
| **General and administrative expenses** | **49,968** | 67,389* | **25,051** | 30,905* | 123,935* |
| Operating income | **260,522** | 278,615 | **139,249** | 145,697 | 559,124 |
| **Financing expenses, net** | **(39,448)** | (62,944) | **(29,321)** | (39,234) | (99,597) |
| **Other income, net** | **107** | 2,872 | **65** | 5,617 | 3,645 |
| Earnings before income tax | **221,181** | 218,543 | **109,993** | 112,080 | 463,172 |
| **Income tax** | **(72,995)** | (73,800) | **(36,393)** | (36,000) | (153,400) |
| Earnings after income tax | **148,186** | 144,743 | **73,600** | 76,080 | 309,772 |
| **Company's equity in losses of an affiliate** | **(6,408)** | (3,282) | **(2,904)** | (876) | (9,080) |
| Net earnings | **141,778** | 141,461 | **70,696** | 75,204 | 300,692 |

* Restated

## 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

| | June 30 2005 (Unaudited) | June 30 2004 (Unaudited) | December 31 2004 (Audited) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **137,105** | 111,184 | 124,393 |
| Broadcasting rights, net | **159,613** | 122,980 | 140,496 |
| Fixed assets, net | **1,078,155** | 1,081,071 | 1,102,066 |
| | **1,374,873** | 1,315,235 | 1,366,955 |
| Current liabilities | **604,918** | 1,910,456 | 595,229 |
| Long-term liabilities | **1,348,381** | 20,862 | 1,299,138 |
| Loans from shareholders | **2,764,591** | 2,418,194 | 2,661,540 |
| Capital deficit | **(3,343,017)** | (3,034,277) | (3,188,952) |
| | **1,374,873** | 1,315,235 | 1,366,955 |

**Notes to the Financial Statements as at June 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 six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues** | **584,933** | 485,870 | **296,271** | 250,082 | 1,027,992 |
| **Operating expenses** | **523,797** | 498,853 | **267,382** | 236,606 | 1,013,403 |
| Operating income (loss) | **61,136** | (12,983) | **28,889** | 13,476 | 14,589 |
| **Sales and marketing expenses** | **66,707** | 60,773 | **33,284** | 32,884 | 133,511 |
| **General and administrative expenses** | **37,990** | 36,058 | **17,846** | 17,266 | 72,240 |
| | **104,697** | 96,831 | **51,130** | 50,150 | 205,751 |
| Operating loss | **(43,561)** | (109,814) | **(22,241)** | (36,674) | (191,162) |
| **Financing expenses, net** | **(100,801)** | (94,304) | **(61,382)** | (58,468) | (171,522) |
| **Other income (expenses), net** | **(88)** | (1,370) | **(8)** | 17 | (3,200) |
| Net loss | **(144,450)** | (205,488) | **(83,631)** | (95,125) | (365,884) |

**Notes to the Financial Statements as at June 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

| | June 30 2005 (Unaudited) | June 30 2004 (Unaudited) | December 31 2004 (Audited) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **285,371** | 168,008* | 223,302* |
| Long-term investments and debit balances | **28,194** | 27,503* | 26,684* |
| Fixed assets | **326,519** | 373,650 | 355,439 |
| Other assets | **16,522** | 11,099 | 18,106 |
| | **656,606** | 581,260 | 623,531 |
| Current liabilities | **220,766** | 249,817 | 239,133 |
| Long-term liabilities | **183,614** | 183,424 | 181,982 |
| Shareholders' equity | **252,226** | 148,019 | 202,416 |
| | **656,606** | 581,260 | 623,531 |

* Restated.

**Notes to the Financial Statements as at June 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 six-month period ended June 30 | | For the three-month period ended June 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2005 (Unaudited) | 2004 (Unaudited) | 2005 (Unaudited) | 2004 (Unaudited) | 2004 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from international telecommunication services** | **402,543** | 401,043 | **203,372** | 203,433 | 816,439 |
| **Operating expenses** | **266,472** | 246,949* | **133,637** | 128,373* | 506,779* |
| Gross profit | **136,071** | 154,094 | **69, 735** | 75, 060 | 309,660 |
| **Marketing, general and administrative expenses** | **93,187** | 88,435* | **47,368** | 43,950* | 191.437* |
| Operating income | **42,884** | 65,659 | **22,367** | 31,110 | 118,223 |
| **Financing expenses, net** | **(3,563)** | (3,687) | **(1,974)** | (581) | (4,301) |
| Earnings after financing, net | **39,321** | 61,972 | **20,393** | 30,529 | 113,922 |
| **Other revenues (expenses), net** | **46** | 4,583 | **(294)** | 3,416 | 4,656 |
| Earnings before income tax | **39,367** | 66,555 | **20,099** | 33,945 | 118,578 |
| **Tax benefit (Income tax)** | **9,978** | (454) | **3,200** | (131) | 822 |
| Earnings after income tax | **49,345** | 66,101 | **23,299** | 33,814 | 119,400 |
| **Company's equity in earnings of an affiliated company** | **1,297** | 838 | **1,093** | 307 | 1,440 |
| Net earnings | **50,642** | 66,939 | **24,392** | 34,121 | 120,840 |

* Restated.

PVI Actuarial Ltd. 58 Rambam, Ra'anana 43602
Tel: (09) 743 1932 / Fax: (09) 741 1189 / dengelma@zahav.net.il

24 July, 2005
17 Tammuz, 5765

Bezeq, The Israel Telecommunications Corp. Ltd.
15 Hazvi Street
Jerusalem

Dear Sir,

Re: Reserve in respect of early retirement
for the balance sheet as at 30th June 2005

**Actuarial Qualifications**

Name: David Engelmayer, Actuary
Education: Qualified actuary – Fellow of the Society of Actuaries in the USA
Member of the Academy of Actuaries in the U.S.A.
Full member of the Association of Actuaries in Israel
M.Sc. in Applied Mathematics, Columbia University, New York
Consent: The actuary consents to publication of the reserve for early retirement

**General**

As requested, we have prepared a calculation for the liability of Bezeq with regard to future early retirements. Currently there remain 922 employees in the potential group, of whom 462 are transferred workers and 460 are not transferred workers (compared to 987 potential retirees at the last valuation, of whom 492 were transferred workers and 495 were not transferred workers). As directed by you, we used a table of remaining expected early retirement for 526 employees under the early retirement agreement reached with the Workers Committee. Of these 526 retirees, 109 will be non-transferred workers and 417 will be transferred workers.

This calculation does not relate to other types of retirement, such as retirement due to death or disability. The calculation was prepared on the basis of data supplied to us, relying on the data and principles of the calculation in the aforementioned agreement.

The retirement schedule for the 526 employees is:

| Retirement Year | Retirees | Retirees (previous valuation) |
|---|---|---|
| 2005 | 112 | 123 |
| 2006 | 200 | 200 |
| 2007 | 100 | 100 |
| 2008 | 114 | 118 |
| **Total** | **526** | **546** |

The retirement of the transferred workers and non-transferred workers is proportional to the total (i.e. about 80% transferred and 20% not transferred), for each calendar year.

The actuarial obligation was calculated using a statistical model which reflects the average expected early retirement costs in each future year.

**Effects of the pension reform**

The pension agreement provides two systems for determining pension rights for retirees among the transferred workers:
Track A – which was determined on the basis of the assessment pension rules in the civil service, i.e. the pension will be determined on the basis of the average of the grades in the last three years prior to the retirement and updated according to the rules for civil servants. The pension in this track is linked to the cost-of-living increments and the wage agreements in the economy.
Track B – was determined on the basis of the Makefet bylaws, i.e. it sets the pension according to a relative salary average called the "averages method", taking into account the best 25 years (hereinafter: "**the Averages Method**"). A pension in this track is linked to the CPI on the dates on which a cost-of-living increment was given in the economy.

In June 2003, as part of the reform of the pension funds, the Knesset passed a law that cancels agreements that benefit the workers and the employers. This included cancellation of the calculation formulae that had applied until the date of the reform between Bezeq and the Makefet Fund, which regulate the accounting in respect of a worker taking early retirement.
In the litigation between Bezeq, the Capital Market, Insurance and Savings Division of the Ministry of Finance and the Makefet Pension Fund, the parties reached consensus that for the population that retired up to 01.10.2003 (exclusive) the same cost calculation method would apply as for those who retired prior to 01.06.2003. Makefet, for its part, agreed to recognize the company's retirees after 1.10.2003 as pensioners of the Fund if the company would pay the costs in accordance with circulars 2000/1 and 2004/8 of the Capital Markets Division.

Starting on 1.10.2003, the standard bylaws apply to members of the Makefet Fund, and the Makefet Fund, for its part, may not grant benefits beyond the standard bylaws. This includes the matter of CPI linkage.

Several principal points from the pension fund reform:
- Cancellation of the Bezeq-Makefet agreement (the alpha formulae).

- The retirement age for men and women will rise gradually to 67 and 64 respectively. The pace of the rise is as determined in the memorandum of understandings between the Ministry of Finance and the trade unions from 5.1.2004.
- Contributions will rise gradually, for the worker from 5.5% to 7% and for the employer from 12% to 13.5%.
- The rights of the workers will be calculated by the Averages Method according to the 35 best years only (cancellation of Track A).
- The worker will pay up to 1.75% management fees from any pension, on a graduated scale (this does not affect the cost of early retirement).
- The pension will be inflation adjusted only after a cumulative inflation increase of 4.25% or every two years – whichever is the earlier.

At the beginning of July 2005, an agreement was signed between Bezeq and Harel Insurance Company, whereby Bezeq makes a single payment to Harel at the time of retirement of each employee and Harel takes responsibility for the payment of the old-age and survivors pensions to the early retirees, as detailed below. Bezeq will freeze contributions to the Makefet pension fund in respect of those employees who take early retirement according to this agreement.

- Early retirement pension – from the date of the early retirement of the employee until their reaching the statutory retirement age (as defined in the Retirement Age Law, 5764-2004), Harel will pay the retiree a monthly pension according to the amount defined by Bezeq.
- Old age pension – from the month after reaching statutory retirement age, Harel will pay a monthly pension to the retiree, whose sum is the difference between the pension set according to Bezeq and the pension being received from the Makefet Pension Fund under the standard bylaws governing the old pension funds (as defined by the Ministry of Finance).
- Survivors' pension – following the death of the retiree, Harel will pay a pension equal to 60% of the old-age pension (i.e. the difference between the Bezeq and the Makefet pensions) to the spouse of the retiree. Each orphan under age 21 will receive 20% of the old-age pension, up to a maximum of 100% of the basic old-age pension for the spouse and orphans combined. In the event that the 100% limit will be passed, the orphans' share (40%) will be divided equally according to the number of eligible orphans. When an orphan reaches age 21, the orphans' share is reallocated for orphans of a transferred employee, and is not reallocated for the orphans of a non-transferred employee. In the event there is no spouse, each orphan receives a double-share (viz. 40%), while the 100% limit remains in effect.
- All pensions are linked to the inflation index as defined by the pension fund regulations.

This agreement forms the basis of the future costs for Bezeq of future early retirement.

## Calculation assumptions

- The agreement between Bezeq and Harel for early retirements (formulae reflecting the agreement can be found as an appendix to the agreement).
- Retirement age: rising to 64/67 in accordance with the Retirement Age Law 5764 – 2004.
- Discount rate: in order to calculate the costs according to the Bezeq-Harel agreement (which specifies that the interest rate varies in line with the duration of the liabilities for each individual employee) we calculated the duration of each individual's liability using a 4% interest rate. The gross interest rate for discounting was then found by linear interpolation of the net redemption yields of the two government bonds with modified durations closest to that of the liability. (A table of government bonds with modified durations and net redemption yields is attached as Appendix Two.) The gross interest thus found was reduced in line with the spread specified by the agreement to arrive at the net interest rate for discounting. For 2005 retirees only, in the event the calculated liability for an employee was within 3 years of the modified duration of the government bond ("Galil" series) with the highest duration, then this duration was used as the gross interest rate.
- Management fees (from pension payments): 1% in 2005, 1.5% in 2006 and 1.75% from 2007 onwards.
- Service costs: according to agreement with Harel
- Mortality: as per circular 2000/1
- Marriage percentage, age differences, orphans: according to employees' actual data.
- Parents: none.
- Retirement grants according to an agreement between the Workers Committee and Bezeq from 2000.
- Salary increases in Track A at 4% per year up to early retirement. Additionally, in keeping with Bezeq's instructions, we have assumed an immediate one-off 1.9% increase in Track A salaries.[1]
- Salary increases in Track B at 1.5% per year up to early retirement[2]
- A worker may take early retirement only if he has accumulated 20 years seniority and he is more than 50 years old.
- The distribution of transferred / non-transferred workers is 421 transferred employees and 105 non-transferred employees.
- Every year, the retirees retire on 1 July of that year, with the exception of 2005 when the retirements are assumed to occur on 1st October, as per Bezeq's instructions.
- Under the standard bylaws, the average wage in the economy does not continue to increase for the purpose of determining the pension of a "frozen" member of the pension fund, but is linked to the inflation index only.
- The "bonus" in accrued pension for Track A is based on full (100%) employment.
- Non-transferred employees' accrued pension percent is calculated, for the purpose of calculating the pension according to Bezeq, using the old tables of the pension fund (Aleph-Tet), according to each individual employee's table, and not using the accrual table of the standard bylaws.
- Pension accrual in Makefet pension fund according to the table in Appendix Bet of the standard bylaws and the standard bylaws.

[1] Needed for calculating pension according to Bezeq.
[2] Needed for calculating pension according to Bezeq and Makefet.

## Results of the calculation

- In the previous quarter the early retirement costs for 546 employees retiring between 2005-2008 according to the division given in the table above, was 833.2 million NIS (676.4 million NIS for pensions, 153.8 million NIS for retirement grants and 3.0 million NIS for standard deviation).
- In the current quarter the early retirement costs, using the same assumptions as the previous quarter, for 526 employees retiring between 2005-2008 according to the division given in the table above, are 797.4 million NIS (646.1 million NIS for pensions, 148.2 million NIS for retirement grants and 3.0 million NIS for standard deviation). The difference derives mainly from the reduction in the number of future retirees.
- In the current quarter the early retirement costs, according to the agreement between Bezeq and Harel, for 526 employees retiring between 2005-2008 according to the division given in the table above, are 691.1 million NIS (540.0 million NIS payment to Harel, 148.1 million NIS for retirement grants and 3.0 million NIS for standard deviation). Detailed results can be found in Appendix One.

We have added one standard deviation to the assessment in respect of uncertainty of who are the workers who will actually retire and when during the year they will retire.[3] In future valuations we expect there to be a further element of variability due to the dependence on market interest rates. In accordance with accounting principles, no extra reserve has been allocated to stabilize the reserves in spite of future interest rate movements.

There is a group of 376 employees who have already retired from Bezeq, for whom no payment has yet been made to Harel under the terms of the Bezeq-Harel agreement. We performed a valuation for these employees, under the same assumptions listed above, with the exception of the retirement date, which was here assumed to be 1st July. Under this valuation the expected cost to Bezeq for these retirees is 347.3 million NIS. Detailed results can be found in Appendix Three.

[3] We note that use of an average as a cost estimate is on the conservative side as the approach of Bezeq is to offer early retirement to the longer-serving employees in the potential population. The cost of early retirement for long-serving employees, despite the higher salary, is lower because the time to official retirement is shorter.

**Miscellaneous – Comparison of quarterly data**

- The salary for Track A rose by an average of 0.6%, which is lower than the model's assumed 4% p.a.
- The salary for Track B rose by an average of 0.8%, which is higher than the model's assumed 1.5% p.a.
- The employees' seniority increased by a quarter of a year for all employees.
- The salary for Histaglut grant fell by 1% on average, whilst for the other grants the salary rose by 0.8% on average, which is lower than the model's assumed 4% p.a.

Yours sincerely,

David Engelmayer, Actuary

## Appendix One: Assessment of balance sheet reserve – according to the Bezeq-Harel agreement

**Potential Pool Of Early Retirees** **922**

***Scheduled Leaves:***

| Retire | Total | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Leaves | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005 | 112 | 0 | 0.0 M | 0.0 M | 4 | 4.9 M | 1.3 M | 2 | 0.7 M | 0.3 M | 6 | 5.6 M | 1.6 M | 7.2 M |
| 2006 | 200 | 0 | 0.0 M | 0.0 M | 2 | 2.2 M | 0.6 M | 2 | 1.0 M | 0.4 M | 4 | 3.2 M | 1.0 M | 4.2 M |
| 2007 | 100 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| 2008 | 114 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| Total | 526 | 0 | 0.0 M | 0.0 M | 6 | 7.1 M | 1.9 M | 4 | 1.7 M | 0.7 M | 10 | 8.8 M | 2.7 M | 11.5 M |

***Other Leaves:***

| Retire | Total | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Leaves | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005 | 112 | 0 | 0.0 M | 0.0 M | 84 | 97.9 M | 26.9 M | 22 | 8.8 M | 4.3 M | 106 | 106.7 M | 31.2 M | 137.9 M |
| 2006 | 200 | 0 | 0.0 M | 0.0 M | 156 | 184.5 M | 47.8 M | 40 | 15.7 M | 7.7 M | 196 | 200.2 M | 55.5 M | 255.7 M |
| 2007 | 100 | 0 | 0.0 M | 0.0 M | 80 | 96.6 M | 23.6 M | 20 | 7.9 M | 3.9 M | 100 | 104.6 M | 27.5 M | 132.0 M |
| 2008 | 114 | 0 | 0.0 M | 0.0 M | 91 | 110.9 M | 26.8 M | 23 | 8.8 M | 4.4 M | 114 | 119.7 M | 31.3 M | 151.0 M |
| Total | 526 | 0 | 0.0 M | 0.0 M | 411 | 490.0 M | 125.1 M | 105 | 41.2 M | 20.4 M | 516 | 531.2 M | 145.5 M | 676.6 M |

***Total Leaves:***

| Retire | Total | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Leaves | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005 | 112 | 0 | 0.0 M | 0.0 M | 88 | 102.8 M | 28.2 M | 24 | 9.5 M | 4.6 M | **112** | **112.3 M** | **32.8 M** | **145.2 M** |
| 2006 | 200 | 0 | 0.0 M | 0.0 M | 158 | 186.7 M | 48.4 M | 42 | 16.7 M | 8.1 M | **200** | **203.4 M** | **56.6 M** | **259.9 M** |
| 2007 | 100 | 0 | 0.0 M | 0.0 M | 80 | 96.6 M | 23.6 M | 20 | 7.9 M | 3.9 M | **100** | **104.6 M** | **27.5 M** | **132.0 M** |
| 2008 | 114 | 0 | 0.0 M | 0.0 M | 91 | 110.9 M | 26.8 M | 23 | 8.8 M | 4.4 M | **114** | **119.7 M** | **31.3 M** | **151.0 M** |
| **Total** | **526** | **0** | **0.0 M** | **0.0 M** | **417** | **497.1 M** | **127.0 M** | **109** | **42.9 M** | **21.1 M** | **526** | **540.0 M** | **148.1 M** | **688.1 M** |

## Appendix Two – Bond Yields

| *Series* | *Modified Duration* | *Redemption Yield* |
|---|---|---|
| Galil 5205 | 0.1616 | 5.931% |
| Galil 5451 | 0.3288 | 1.565% |
| Galil 5610 | 0.3288 | 1.835% |
| Galil 5207 | 1.1370 | 2.071% |
| Galil 5208 | 1.3862 | 2.110% |
| Galil 4701 | 1.7998 | 2.078% |
| Galil 5701 | 1.9599 | 2.270% |
| Galil 4702 | 1.9642 | 2.094% |
| Galil 5501 | 2.1086 | 2.165% |
| Galil 4703 | 2.5079 | 2.115% |
| Galil 5416 | 2.6716 | 2.394% |
| Galil 5704 | 2.9086 | 2.335% |
| Galil 5417 | 2.9358 | 2.507% |
| Galil 5418 | 3.1874 | 2.515% |
| Galil 5419 | 3.4363 | 2.596% |
| Galil 5901 | 3.8061 | 2.761% |
| Galil 5420 | 3.8490 | 2.674% |
| Galil 5421 | 4.0084 | 2.833% |
| Galil 5423 | 4.4166 | 2.799% |
| Galil 5425 | 4.7255 | 2.874% |
| Galil 5424 | 4.7551 | 2.800% |
| Galil 5426 | 4.9780 | 2.963% |
| Galil 5480 | 5.5323 | 3.163% |
| Galil 5481 | 6.1830 | 3.350% |
| Galil 5427 | 6.4968 | 3.350% |
| Galil 5470 | 7.3543 | 3.495% |
| Galil 5471א | 8.1166 | 3.715% |
| Galil 5472 | 8.2777 | 3.725% |
| Galil 5903 | 11.7300 | 4.049% |
| Galil 5904 | 13.2174 | 4.083% |

## Appendix Three – Liability for employees who have already retired

**Potential Pool Of Early Retirees** **376**

***Scheduled Leaves:***

| Retire Year | Total Leaves | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005 | 376 | 0 | 0.0 M | 0.0 M | 323 | 328.8 M | 0.0 M | 53 | 18.4 M | 0.0 M | 376 | 347.3 M | 0.0 M | 0.0 M |
| 2006 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| 2007 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| 2008 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| Total | 376 | 0 | 0.0 M | 0.0 M | 323 | 328.8 M | 0.0 M | 53 | 18.4 M | 0.0 M | 376 | 347.3 M | 0.0 M | 0.0 M |

***Other Leaves:***

| Retire Year | Total Leaves | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| 2006 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| 2007 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| 2008 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| Total | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |

***Total Leaves:***

| Retire Year | Total Leaves | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Number | Reserve | Ma'anak | Total |
| 2005 | 376 | 0 | 0.0 M | 0.0 M | 323 | 328.8 M | 0.0 M | 53 | 18.4 M | 0.0 M | **376** | **347.3 M** | **0.0 M** | **0.0 M** |
| 2006 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | **0** | **0.0 M** | **0.0 M** | **0.0 M** |
| 2007 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | **0** | **0.0 M** | **0.0 M** | **0.0 M** |
| 2008 | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | **0** | **0.0 M** | **0.0 M** | **0.0 M** |
| **Total** | **376** | **0** | **0.0 M** | **0.0 M** | **323** | **328.8 M** | **0.0 M** | **53** | **18.4 M** | **0.0 M** | **376** | **347.3 M** | **0.0 M** | **0.0 M** |