INTERNET GOLD GOLDEN LINES LTD
Form 20-F
April 30, 2012

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SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

FORM 20-F

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2011

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________ to __________

o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Date of event requiring this shell company report ____________

Commission file number: 0-30198

INTERNET GOLD – GOLDEN LINES LTD.
(Exact name of Registrant as specified in its charter
and translation of Registrant's name into English)

Israel
(Jurisdiction of incorporation or organization)

2 Dov Friedman Street, Ramat Gan 52503, Israel
(Address of principal executive offices)

Doron Turgeman, CEO, +972-3-9240000 (phone), +972-3-9399832 (fax)
2 Dov Friedman Street, Ramat Gan 52503, Israel
(Name, Telephone, E-mail and/or Facsimile Number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which

	registered
Ordinary Shares, NIS 0.01 Par Value	NASDAQ Global Select Market

Securities registered or to be registered pursuant to Section 12(g) of the Act: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, par value NIS 0.01 per share ……………19,203,078

(as of December 31, 2011)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No x

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP o	International Financial Reporting Standards as issued by the International Accounting Standards Board x	Other o

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

INTRODUCTION

We are a leading communications group in Israel. Our shares are listed on the NASDAQ Global Select Market and on the Tel Aviv Stock Exchange, or TASE. Our subsidiaries are B Communications Ltd. (formerly known as 012 Smile.Communications Ltd.) and Goldmind Media Ltd. (formerly known as Smile.Media Ltd.). As used in this annual report, the terms "we," "us" and "our" mean Internet Gold - Golden Lines Ltd. and its subsidiaries, "B Communications" means B Communications Ltd., Goldmind means Goldmind Media Ltd., "Eurocom Communications" means Eurocom Communications Ltd., "Bezeq" means Bezeq - The Israel Telecommunications Corp., Ltd.; "Pelephone" means Pelephone Communications Ltd., "Bezeq International" means Bezeq International Ltd. and "DBS" or "YES" (the trade name for DBS) means DBS Satellite Service (1998) Ltd. Bezeq, Pelephone, Bezeq International and DBS are sometimes referred to as the Bezeq Group in this annual report.

On April 14, 2010, our principal subsidiary, B Communications, completed the acquisition of the controlling 30.44% interest in Bezeq (TASE:BZEQ), Israel's largest telecommunications provider, from Ap.Sb.Ar. Holdings Ltd. (a consortium of Apax Partners, Saban Capital Group and Arkin Communications) for an aggregate cash purchase price of approximately NIS 6.5 billion. In accordance with the terms of the transaction, effective as of the closing of the acquisition, B Communications designated seven directors to replace the Apax-Saban-Arkin Group's representatives on Bezeq's Board of Directors, which numbers 13 directors. We began consolidating Bezeq's financial results into our financial statements effective as of the closing of the acquisition. On March 14, 2011, B Communications purchased an additional 14,590,000 ordinary shares of Bezeq at NIS 10.1716 per share, further increasing its ownership interest in Bezeq to 31.37% of its outstanding shares (30.14% on a fully diluted basis). As of April 30, 2012 B Communications ownership interest in Bezeq declined to 31.05% due to Bezeq employee stock option exercises.

Prior to January 2010, B Communications offered a wide range of broadband and traditional voice services in Israel, which we refer to in this annual report as the legacy communications business. As part of its acquisition of the controlling interest in Bezeq, on November 16, 2009, B Communications entered into an agreement to sell its legacy communications business (excluding certain retained indebtedness and liabilities) to a wholly-owned subsidiary of Ampal-American Israel Corporation, or Ampal, for NIS 1.2 billion. The sale of B Communications' legacy communications business to Ampal was completed on January 31, 2010, and was effective as of January 1, 2010.

B Communications changed its name from 012 Smile.Communications Ltd. to B Communications Ltd. on March 16, 2010 in connection with its acquisition of the controlling interest in Bezeq. B Communications' ordinary shares are listed on the NASDAQ Global Select Market (symbol: BCOM) and on the TASE. We currently own 78.11% of the ordinary shares of B Communications.

Effective as of January 1, 2009, we adopted International Financial Reporting Standards, IFRS, as issued by the International Accounting Standards Board, or the IASB, replacing the previous reporting standard which was generally accepted accounting principles in the United States, or U.S. GAAP. Accordingly, beginning January 1, 2009, we prepare our consolidated financial data according to IFRS as issued by the IASB. Our transition date to IFRS under First Time Adoption of International Financial Reporting Standards was January 1, 2008. Comparative data of our financial statements has been restated to retrospectively reflect the adoption of IFRS. Our consolidated financial statements appearing in this annual report are prepared in New Israeli Shekels, or NIS, and are translated into U.S. dollars at the representative rate of exchange at December 31, 2011 (NIS 3.821 = $1.00). The dollar amounts so presented should not be construed as representing amounts receivable, payable or incurred in dollars or convertible into dollars. All references in this annual report to "dollars" or "$" are to U.S. dollars and all references in this annual report to "NIS" are to New Israeli Shekels.

Statements made in this annual report concerning the contents of any contract, agreement or other document are summaries of such contracts, agreements or documents and are not complete descriptions of all of their terms. If we filed any of these documents as an exhibit to this annual report or to any registration statement or annual report that we previously filed, you may read the document itself for a complete description of its terms.

Forward Looking Statement

Except for the historical information contained in this annual report, the statements contained in this annual report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995, as amended, with respect to our business, financial condition and results of operations. Such forward-looking statements reflect our current view with respect to future events and financial results. We urge you to consider that statements which use the terms "anticipate," "believe," "do not believe," "expect," "plan," "intend," "estimate," "anticipate" and similar expressions are intended to identify forward-looking statements. We remind readers that forward-looking statements are merely predictions and therefore inherently subject to uncertainties and other factors and involve known and unknown risks that could cause the actual results, performance, levels of activity, or our achievements, or industry results, to be materially different from any future results, performance, levels of activity, or our achievements expressed or implied by such forward-looking statements. Such forward-looking statements are also included in Item 4 – "Information on the Company" and Item 5 – "Operating and Financial Review and Prospects." Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by applicable law, including the securities laws of the United States, we undertake no obligation to publicly release any update or revision to any forward-looking statements to reflect new information, future events or circumstances, or otherwise after the date hereof. We have attempted to identify significant uncertainties and other factors affecting forward-looking statements in the Risk Factors section that appears in Item 3.D. "Key Information - Risk Factors.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

Effective as of January 1, 2009, we adopted International Financial Reporting Standards, IFRS, as issued by the International Accounting Standards Board, or the IASB, replacing the previous reporting standard which was generally accepted accounting principles in the United States, or U.S. GAAP. Accordingly, beginning January 1, 2009, we prepare our consolidated financial data according to IFRS as issued by the IASB. Our transition date to IFRS under First Time Adoption of International Financial Reporting Standards was January 1, 2008. Comparative data of our financial statements has been restated to retrospectively reflect the adoption of IFRS.

IFRS

The tables below at and for the years ended December 31, 2008, 2009, 2010 and 2011 set forth selected consolidated financial data under IFRS, which is derived from our audited consolidated financial statements. The audited consolidated financial statements as of December 31, 2010 and 2011 and for the years ended December 31, 2008, 2009, 2010 and 2011 appear in this annual report.

Statement of Operations Data:

	Year Ended December 31,				
	2008	2009	2010	2011	2011
	(NIS in millions, except shares and per share data)				($ in thousands, except share and per share data)
Revenues	1,167	1,243	8,732	11,376	2,977
Depreciation and amortization	117	99	2,295	2,984	781
Salaries	184	171	1,500	2,122	555
General and operating expenses	741	811	3,711	4,468	1,169
Other operating expenses (income),net	(6)	2	(3)	323	85
	1,037	1,083	7,503	9,897	2,590
Operating income	130	160	1,229	1,479	387
Finance expense	139	134	716	1,077	281
Finance income	(27)	(132)	(327)	(497)	(130)
Finance expense, net	112	2	389	580	151
Income after financing expenses	18	158	840	899	236

Share of losses in equity-accounted investees	-	-	235	216	57
Income before income tax	18	158	605	683	179
Income tax	22	58	385	653	171
Income (loss) for the year	(4)	100	220	30	8
Income (loss) attributable to owners of the Company	(18)	62	(209)	(266)	(69)
Income (loss) attributable to non-controlling interest	14	38	429	296	77
Net income (loss) for the year	(4)	100	220	30	8
Basic earnings (loss) per share	(0.85)	3.39	(11.11)	(13.56)	(3.55)
Diluted earnings (loss) per share	(0.89)	3.39	(11.23)	(13.60)	(3.56)

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Statements of Financial Position Data:

	As at December 31,				
	2008	2009	2010	2011	2011
			(NIS in millions)		($ in thousands)
Cash and cash equivalents	86	1,350	404	1,447	379
Total assets	1,901	2,846	24,320	25,259	6,611
Total current liabilities	424	1,009	4,305	4,787	1,253
Total non-current liabilities	885	1,144	12,304	16,231	4,248

U.S. GAAP:

The table below sets forth a selected consolidated financial information under U.S. GAAP for the year ended December 31, 2007, which has been derived from our previously published audited consolidated financial statements for that year.

Statement of Operations Data:

	Year Ended December 31, 2007 (NIS in millions, except share and per share data)
Operating expenses:	
Cost of revenues	802
Selling and marketing	176
General and administrative	70
Impairment and other expenses, net	15
Total operating expenses	1,063
Operating income	113
Financial expenses, net	58
Gain from issuance of shares in a subsidiary	120
Income before income taxes	176
Income tax expenses	50
Income after income tax	125
Minority share in income	(1)
Net income	124
Earnings per ordinary share - basic	5.74
Weighted average number of shares used in the calculation	21,617
Earnings per ordinary share - diluted	5.44
Weighted average number of shares used in the calculation	24,795

* Represents an amount less than NIS 1 million

U. S. GAAP

Statements of Financial Position Data:

	As of December 31, 2007 (NIS in millions)
Cash and cash equivalents	230
Total assets	1,554
Total short-term debt	112
Total long-term loans (net of current maturities)	440

Exchange Rate Information

The following table sets forth, for the periods and dates indicated, certain information regarding the Bank of Israel representative rate of exchange for dollars, expressed in NIS per one dollar. The representative rate is the average between the buying rate and the selling rate of exchange. We do not use such rates in the preparation of our consolidated financial statements included elsewhere herein. See Note 2 to the consolidated financial statements included elsewhere in this Form 20-F.

Period	Average	High	Low	At Period Ended
Year ended December 31, 2007	4.110	4.342	3.830	3.846
Year ended December 31, 2008	3.586	4.022	3.230	3.802
Year ended December 31, 2009	3.923	4.256	3.690	3.775
Year ended December 31, 2010	3.723	3.894	3.549	3.549
Year ended December 31, 2011	3.579	3.821	3.363	3.821

Period	High	Low
November 2011	3.800	3.665
December 2011	3.821	3.727
January 2012	3.854	3.733
February 2012	3.803	3.700
March 2012	3.814	3.715
April 2012	3.769	3.723

On April 27, 2012, the representative rate of exchange was NIS 3.750 = $1.00 as published by the Bank of Israel.

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Risks Related to the Business of Bezeq

Investing in our ordinary shares involves a high degree of risk and uncertainty. You should carefully consider the risks and uncertainties described below before investing in our ordinary shares. If any of the following risks actually occurs, our business, prospects, financial condition and results of operations could be harmed. In that case, the value of our ordinary shares could decline, and you could lose all or part of your investment.

Bezeq's competition from other telecommunications providers, and potential changes in the competitive environment and communications technologies, could adversely affect its business and our results of operations.

Competition in the voice, cellular and Internet services markets in Israel is intensifying. The main characteristic of market competition in 2011 was the continued consolidation of communication groups and their offering comprehensive service packages and products. As reflected in the following table, four main groups, consisting of companies under common or joint control, operate in the communications market in Israel today: the Bezeq Group, the IDB group, Partner Communications Company Ltd., or Partner, and HOT Telecom, or HOT, a cable communications company and together with Mirs Communications Ltd., or Mirs, the HOT-Mirs Group.

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

While in the past the competition in the communications market was mainly among independent communications services providers in each segment separately, more recently and especially in the last year, the trend has reflected increased competition among communications groups. In some cases, the groups operate on the basis of marketing cooperation among the various communications providers in the group so as to provide comprehensive communications services, utilizing the marketing and operational advantage inherent in such a structure, while in other cases where there is no cooperation of this kind at present, there is likely to be cooperation in the future in view of the control links between the companies and the changing regulatory policy affecting the industry.

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

We believe that the Bezeq Group is subject to stricter limitations than those which apply to the other communications groups, including among other things structural separation limitations and a limitation on marketing "joint" service packages.

During 2011, a tender was issued to grant frequencies and licenses for cellular operators that own infrastructure. The tender was awarded to Mirs (part of the HOT-Mirs Group) and Golan Telecom Ltd., or Golan. Under the tender conditions, the winners will be able to launch their activity after they have deployed a cellular network that initially covers 10% of the population of the State of Israel. Following this deployment, the new operators will be able to utilize the existing operator networks for a period of up to 7 years (with a possible extension based on approval for three more years), and based on the national roaming model.

Another characteristic of market competition in 2011 was the continued actions to promote the entry of mobile virtual network operators, or MVNOs, into Israel's cellular market. During 2010 and 2011, several licenses were issued to MVNOs. To date, Rami Levi Cellular Communications Ltd. is the only new cellular operator to have commenced operations. Pelephone signed agreements with two MVNOs, including Rami Levi Cellular Communications Ltd. that will enable the MVNOs to use Pelephone's infrastructure and network in order to service their customers and operation. Pelephone anticipates that the entry of the new operators will intensify competition in the cellular market.

In October 2011, the Hayek Committee, a committee appointed by the Israeli Ministers of Communications and Finance, published its final report relating to significant regulatory aspects affecting the Israeli communications market. If the recommendations are adopted, they may have a significant influence on competition in the markets in which the Bezeq Group operates.

Bezeq operates in a highly regulated telecommunications market which limits its flexibility in managing its business and may materially and adversely affect our results of operations.

Bezeq operates in a highly regulated industry in Israel, which limits its flexibility in managing its business, mainly with respect to the land-line market. Bezeq is subject to government supervision and regulation relating to, among other things, licensing for activity, determining permitted areas of activity, determining tariffs, operation, competition, environment, payment of royalties, obligation to provide universal service, ability to hold its shares, relationships between Bezeq and its subsidiaries and prohibition to terminate or restrict its services (which may force Bezeq to provide services even when not economically feasible). This supervision and regulation at times lead to the intervention of the State of Israel. Bezeq's business and operations could be adversely affected by decisions by regulators, in particular the Ministry of Communications as well as changes in laws, regulations or government policy affecting its business activities. Further risks and uncertainties result from the fact that changes in such laws, regulations or government policies may not be adopted or implemented in the manner that Bezeq expects and may be further amended, interpreted or enforced in an unexpected manner or in a manner adverse to Bezeq's business and results of operations

Bezeq may face difficulties in obtaining some of the building and environmental permits required for the establishment and operation of its network sites, which could have an adverse effect on the coverage, quality and capacity of its network.

Bezeq, mainly with respect to its Pelephone cellular operations, is subject to the Israeli Non-Ionizing Radiation Law, 5766-2006, or the Radiation Law, which regulates the emission of electromagnetic radiation from broadcast facilities. The Radiation Law prohibits, among other things, the erection or operation of a source of radiation in contravention of any applicable permit and the erection or operation of a source of radiation without a permit. After receiving a written warning from the authorities, failure to remedy a violation will subject the permit holder to criminal prosecution on a strict liability basis. Pelephone is currently working to obtain permits to set up and operate its various broadcasting installations; however, the policies maintained by the various relevant entities and amendments to applicable statutes and standards could adversely impact the infrastructure of such installations and the regularity of the services using the infrastructure. As a result, Bezeq's revenues from these services could be adversely affected.

In addition, the establishment and operation of cellular antennas are subject to building permits from various planning and building committees, a process that involves a number of approvals from Israeli state entities and regulatory bodies. The foregoing may impair the quality and capacity of Bezeq's and Pelephone's existing networks and the deployment of new networks.

Actual and alleged health risks related to cellular network sites and mobile telecommunication devices could have a material adverse effect on our business, operations and financial condition.

Cellular network sites, handsets and accessories are known to be sources of non-ionizing radiation emissions. Pelephone takes steps to ensure that the levels of radiation emitted by these transmission facilities, equipment and devices do not exceed the levels of radiation permitted in the directives of the Israeli Ministry of Environment Protection (levels adopted in accordance with international standards). However, health risks may be found to exist and transmission sites or devices and equipment may emit more radiation than that allowed in radiation standards, causing a risk to health, which may have an adverse effect on our business and could result in a reduction in the use of cellular services, difficulty in renting sites, claims for physical and property damages in substantial amounts and attempts to exercise the deeds of indemnity that Pelephone deposited with the planning authorities pursuant to the Planning and Building Law. Pelephone’s third-party liability policy does not currently cover electromagnetic radiation.

Bezeq’s tariffs for its services are subject to government control, which harms its ability to compete and results in an erosion of its tariffs, which adversely affects its business.

Bezeq’s tariffs for its services are subject to government control. Some of these tariffs are stipulated in regulations and these regulations also stipulate a formula for updating tariffs. Bezeq is restricted in its ability to give discounts on its principal services and to offer differential tariffs. Further, alternative payment packages, which should provide an immediate alternative to the regulated tariffs, are currently subject to certain conditions which often render the alternative payment package option moot. The foregoing factors harm Bezeq’s ability to compete and results in an erosion of its tariffs, which adversely impacts its business.

On March 28, 2010, the Ministries of Communications and Finance announced the appointment of the Hayek Committee that was tasked with considering a new tariff arrangement for Bezeq, including determining new tariffs relating to the provision of services in the wholesale market for fixed-line communications (including resale and the provision of access to infrastructure) and call completion tariffs in the fixed-line networks. On October 4, 2011, the Hayek Committee published its report including final recommendations. The committee's recommendations are subject to the approval of the Ministers of Communications and Finance, and, if adopted, they may have a significant influence on the markets in which the Bezeq Group operates.

Bezeq is subject to restrictions on intercompany relations with affiliated companies, which harms its ability to compete and adversely affects its business.

Bezeq’s general license for fixed-line communication services obligates it to ensure that its relationships with its principal subsidiaries do not result in favoring them over their competitors. Bezeq is also subject to various limitations as a result of its declaration as a monopoly in the fixed line services business, as well as limitations set forth in merger approvals granted by the Israeli Antitrust Commission. Separation is required between the managements of Bezeq and such other companies, as is separation between the financial and marketing systems, assets and employees, which causes high administration overheads. Bezeq is also subject to limitations with respect to the offering of joint service packages with those companies, which adversely impacts its business, particularly in light of the recent entry into the market of communications companies competing directly with Bezeq in most of its areas of operation based on the provision of bundled services to the customer.

Natural disasters, terrorist attacks or breaches of network or information technology security could have an adverse effect on Bezeq’s business.

Natural disasters, terrorist acts, acts of war, cyber attacks or other breaches of network or information technology (IT) security may cause equipment failures or disrupt Bezeq’s systems and operations. While we maintain insurance coverage for some of these events, the potential liabilities associated with these events could exceed the insurance coverage we maintain. Our inability to operate our facilities as a result of such events, even for a limited period of time, may result in significant expenses and/or loss of market share to other telecommunications providers. In addition, a failure to protect the privacy of customer and employee confidential data against breaches of network or IT security could result in damage to Bezeq’s reputation. Any of these occurrences could result in a material adverse effect on our results of operations and financial condition.

Bezeq’s systems and operations are vulnerable to damage or interruption, which could expose it to material risk of loss or litigation.

Bezeq provides services using various infrastructure systems that include, exchanges, transmission, data communication and access systems, cables and computerized systems. Some of Bezeq's systems have backup, but nevertheless, damage to some or all of these systems, whether due to a technical fault or natural disaster, could cause extreme difficulties in providing service, including if Bezeq is unable to repair the systems.

Bezeq is currently deploying its next generation network, which to a large extent will replace its traditional networks. The set-up of a new network based on advanced technology involves operational and business risks, such as damaging the continuity and quality of the services provided to Bezeq's customers, which could adversely impact its business.

Pelephone’s operations in the cellular market are exposed to losses in the event of malfunctions in the terminal equipment that it sells, including various property risks and liabilities. Pelephone’s cellular information systems are networked throughout the country through designated communications lines and via the Internet, and its cellular business is highly dependent upon these systems. Wide-scale malicious harm or malfunction might adversely affect Pelephone’s cellular business and financial results. Also, Pelephone’s cellular communications network is deployed around the country through network core sites and antenna sites and it cellular business is totally dependent upon these systems. Damage caused by natural or other disasters, war or damage to the switching farm and/or servers used by Pelephone for its core cellular activities could have an adverse effect on its business and results of operations. Pelephone’s cellular business uses two frequency ranges: 850 MHz and 2100 MHz. These frequencies are exposed to interruptions and could impair service quality of the networks that it operates.

Pelephone’s assigned frequency may not easily support the implementation of new technologies, which could have an adverse effect on Pelephone’s competitive position in the cellular market.

In certain situations the 850 MHz frequency available to Pelephone may not easily support the implementation of new technologies emerging in the cellular communication sector, which could make it difficult for Pelephone to implement them. This would have an adverse effect on Pelephone's competitive status, since the other licensees have other frequencies available to them, some of which may support those technologies, while obtaining new frequencies may be difficult. Furthermore, Pelephone’s frequencies are exposed to interference and could impair service quality of networks operated by Pelephone. The factors that could cause interference include among other things, the fact that the 850 MHz frequency is also used for terrestrial television broadcasts, and television stations broadcasting in the Middle East (mainly in Cyprus), which use could cause interference in Pelephone’s 850 MHz EVDO/XRTT1 and UMTS/HSPA networks.

Bezeq and its subsidiaries are parties to legal proceedings, which could result in them being ordered to pay significant sums.

Bezeq and its subsidiaries are parties legal proceedings, including class actions, which could result in them being ordered to pay significant sums, the amount of which cannot be estimated. Class action claims can reach large amounts, as virtually all residents of Israel are consumers of Bezeq’s services and a claim that relates to a minor loss for a single consumer can become a material claim for Bezeq if it is certified as a class action applicable to all consumers or a significant portion of them. In addition, since Bezeq provides communications infrastructure as well as billing services to other licensees, parties suing those licensees in other class actions may also try to involve Bezeq as a party to such proceedings.

The market in which Bezeq operates is characterized by material capital investments in infrastructure and subscriber equipment and changing technology, which imposes a heavy financial burden on Bezeq.

The market in which Bezeq operates is characterized by material capital investments in infrastructure and subscriber equipment and changing technology. The frequent technological changes in infrastructure and terminal equipment and the intense competition in various market segments impose a heavy financial burden on the companies operating in the market, requiring them to update their infrastructure technology from time to time or to introduce new devices into the market at heavy cost. The development of new technologies can render existing technologies obsolete, resulting in the need for large monetary investments in order to retain a competitive position. Bezeq’s future success will depend on its ability to develop and introduce, on a timely and cost-effective basis, new infrastructure and subscriber equipment that keep pace with technological developments. If Bezeq is unable to respond promptly and effectively to changing technology, it will be unable to compete effectively in the future and its business could be adversely affected.

Bezeq’s results of operations are subject to market risks such as currency fluctuations, inflation in Israel and the financial condition of the market in Israel and worldwide.

Bezeq’s results of operations are subject to market risks such as currency fluctuations, inflation in Israel and the financial condition of the market in Israel and worldwide. Bezeq measures exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities, based on the type of linkage. In addition, Bezeq has exposure to inflation changes in Israel is high. Bezeq’s also has exposure to market risk for changes in interest rates relating to its borrowings.

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Bezeq collects payments from some of its customers in foreign currency, primarily U.S. dollars. In addition, Bezeq consumes services from suppliers outside Israel and pays for these services in foreign currency, primarily U.S. dollars. Changes in the exchange rates of the currencies in which Bezeq operates, primarily the NIS against the U.S. dollar, could have an adverse effect on Bezeq's cash flow and profitability.

Market and financial stability and the strength of the economy in Israel and worldwide have recently been subject to great volatility and led to a global economic slowdown. Although global economic conditions have begun to stabilize or improve, if the local market weakens, Bezeq's business results could be harmed and its revenues may decline.

Risks Related to Our Company

We and B Communications have a substantial amount of debt, which could restrict our financing and operating flexibility and have other adverse consequences; our ability to repay our debt may be affected by Bezeq's distribution policy and the amount of dividends we receive from Bezeq.

To facilitate the funding of its acquisition of the controlling interest in Bezeq, B Communications entered into two financing agreements under which it received loans in a total principal amount of NIS 5.1 billion, of which NIS 3 billion (approximately $1 billion) was outstanding at December 31, 2011. The financing agreements include certain financial covenants, including, among other things, the requirement that Bezeq maintain certain minimum shareholders equity and minimum ratio of shareholders' equity. In addition, B Communications' wholly-owned subsidiary that directly holds the Bezeq interest must maintain a minimum ratio of debt to EBITDA and a debt service coverage ratio. The Bezeq shares that were acquired and all of such subsidiary's other rights and assets (except for 29,662,168 ordinary shares of Bezeq that were acquired in 2011 and such additional Bezeq shares that may be acquired in the future) have been pledged to the lenders as security under the loan agreements. In addition, B Communications has pledged to the lenders the entire equity it holds in the subsidiary established to acquire the Bezeq shares and the debt owed by such subsidiary. Our ability to repay our debt and B Communications' ability to repay its debt may be affected by Bezeq's distribution policy and the amount of dividends received from Bezeq. If we and B Communications are unable to meet our debt obligations or comply with our debt covenants, we could be forced to renegotiate or refinance our indebtedness, seek additional equity capital or sell assets. We may be unable to obtain financing or sell assets on satisfactory terms, or at all. For more information regarding our debt instruments and our consolidated indebtedness, see Item 5.B "Operating and Financial Review and Prospects - Liquidity and Capital Resources."

Our operating results may be adversely affected by significant fluctuations in the Israeli consumer price index and in interest rates.

As the principal amount of, and interest that we pay on, certain of our debentures and a significant portion of our bank loans are linked to the Israeli Consumer Price Index, or CPI, or are subject to variable interest rate, any increase in the Israeli CPI or in the interest rate will increase our financial expenses and could adversely affect our results. In addition, Bezeq's tariff updating mechanism, which is subject to government regulation, is reviewed once a year and is influenced by the CPI. As a result, the annual rate of inflation and its distribution during the year can have a material influence on the erosion of Bezeq's tariffs and its revenues and expenses during the year.

Our exposure to market risk for changes in interest rates also relates to our investment in marketable securities. Investments in both fixed rate and floating rate interest bearing securities carry a degree of interest rate risk. The market pricing for such fixed rate securities may be adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our future financial results may be negatively affected in the event that interest rates fluctuate.

If we, B Communications or any other member of the Eurocom group subject to the control permit for the acquisition of the controlling interest in Bezeq fails to comply with such permit or other regulatory provisions relating to the control of Bezeq, the control permit could be revoked and our rights with respect to our Bezeq interest would be adversely impacted, which would have a material adverse effect on our business and financial position.

As part of the acquisition of the controlling interest in Bezeq, we, B Communications, B Communications (SP2) Ltd., its indirect fully owned subsidiary which holds the Bezeq interest, or SP2, B Communications (SP1) Ltd., its wholly-owned subsidiary that directly owns SP2, or SP1 and other members of the Eurocom group were granted a permit to control Bezeq, pursuant to the Israeli Communications Law (Telecommunications and Broadcasting), 1982, or the Communications Law, the Communications Order (Determination of Essential Service Provided by “Bezeq” The Israel Telecommunication Corp. Limited), 5757-1997, or the Communications Order. The control permit includes several conditions, including, among others, the requirement that SP2 be controlled exclusively by the other parties to the control permit and that the parties to the control permit hold not less than 30% of any type of means of control of Bezeq and SP2. In February 2011, the Prime Minister and Minister of Communications gave approval for such holdings to reach 29% in the event of dilution resulting from the exercise of stock options by Bezeq employees, for a period of six months commencing from the date such holdings fall below 30%. In addition, the control permit requires that a certain percentage of SP2 be held at all times by an “Israeli Party,” as defined in the Communications Order. The control permit also includes certain notice requirements regarding changes in the composition of the board of directors and certain holdings in us and B Communications. If we, B Communications or any other member of the Eurocom group subject to the control permit fails to comply with the terms of the control permit or with other regulatory provisions relating to the control of Bezeq, such permit could be revoked and our rights with respect to our Bezeq interest would be adversely impacted, which would have a material adverse effect on our business and financial position.

If we do not maintain control of Bezeq we may be deemed to be an “investment company” under the Investment Company Act of 1940, which could have a material adverse effect on our business.

Section 3(a)(1)(A) of the Investment Company Act of 1940, or the Investment Company Act, defines an investment company as any issuer that is, holds itself out as being, or proposes to be, primarily engaged in the business of investing, reinvesting or trading in securities and Section 3(a)(1)(C) of the Investment Company Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire “investment securities” (within the meaning of the Investment Company Act) having a value exceeding 40% of the value of the issuer’s total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. However, an issuer will be deemed not to be an investment company if no more than 45% of the value of such issuer’s total assets (exclusive of government securities and cash items) consists of, and no more than 45% of such issuer’s net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than, among other things, securities issued by companies which are controlled primarily by such issuer. Primary control is presumed if the issuer owns over 25% of the controlled company’s voting securities and the issuer has control greater than that of any other person. Accordingly, so long as we maintain control of Bezeq, we will not be deemed an investment company.

If we were to no longer maintain the control of Bezeq, we could, among other things, be required either (i) to change substantially the manner in which we conduct our operations to avoid being subject to the Investment Company Act or (ii) to register as an investment company. An investment company that is organized under the laws of a foreign country may not register as an investment company, or publicly offer its securities through interstate commerce in the United States, unless the company applies to the Securities and Exchange Commission for an order permitting the company to register under the Investment Company Act, and to make a public offering in the United States. The Securities and Exchange Commission may issue an order granting the application if it finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of the Investment Company Act against the issuer, and further finds that granting the application is otherwise consistent with the public interest and the protection of investors.

If we were required to register as an investment company under the Investment Company Act, we would become subject to substantial regulation with respect to our capital structure (including our ability to use leverage), management, operations, transactions with certain affiliates, reporting, record keeping, voting, proxy and disclosure requirements, and meeting these requirements would be costly, if at all possible.

We may fail to maintain effective internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, which could have an adverse effect on our financial results and the market price of our ordinary shares.

Section 404 of the Sarbanes-Oxley Act requires any company subject to the reporting requirements of the U.S. securities laws to do a comprehensive evaluation of its and its combined subsidiaries’ internal control over financial reporting. To comply with this statute, we are required to document and test our internal control over financial reporting, and our independent registered public accounting firm must issue an attestation report on our internal control procedures, and our management is required to assess and issue a report concerning our internal control over financial reporting. The rules governing the standards that must be met for management to assess our internal control over financial reporting are relatively new and complex and require significant documentation, testing and possible remediation to meet the detailed standards under the rules.

Beginning in the 2010 second quarter, we began consolidating Bezeq's financials results into our financial statements following our acquisition of the controlling interest in Bezeq. Effective for the year ended December 31, 2011, our management report on internal control over financial reporting and our independent registered public accounting firm's attestation report must include an assessment with respect to Bezeq's internal control over financial reporting. Prior to our acquisition of the controlling interest, Bezeq was not subject to Section 404 of the Sarbanes-Oxley Act. We may in the future identify a material weakness in Bezeq's internal control over financial reporting. Failure to maintain effective internal control over financial reporting could result in investigation or sanctions by regulatory authorities and could have a material adverse effect on our operating results, investor confidence in our reported financial information and the market price of our ordinary shares.

Risks Related to Our Relationship with Eurocom Communications Ltd. and B Communications

Because Eurocom Communications controls substantially all the voting power of our ordinary shares, investors will not be able to affect the outcome of all shareholder votes.

Eurocom Communications beneficially owned 78.97% of our outstanding ordinary shares, as of April 30, 2012. Mr. Shaul Elovitch, the chairman of our board of directors and the chairman of the board of directors of Eurocom Communications, and the controlling shareholder of Eurocom Communications, will be able to exercise control over our operations and business strategy and control the outcome of all matters involving shareholder approval.

For as long as Eurocom Communications has a controlling interest in our company, it and Mr. Elovitch indirectly, will have the power to determine or significantly influence the outcome of matters submitted to a vote of our shareholders, including the power to elect all of the members of our board of directors (except outside directors, within the meaning of Israeli law), prevent an acquisition or any other change in control of our company and will have the ability to exercise a controlling influence over our business and affairs, including any determinations with respect to potential mergers or other business combinations involving us, our acquisition or disposition of assets, our incurrence of indebtedness, our issuance of any additional ordinary shares or other equity securities, our repurchase or redemption of ordinary shares and our payment of dividends. Because the interests of Eurocom Communications and Mr. Elovitch may differ from the interests of our other shareholders, actions taken by Eurocom Communications with respect to us may not be favorable to our other shareholders. See Item 10B. "Additional Information - Memorandum and Articles of Association" and Item 7B. "Major Shareholders and Related Party Transactions - Related Party Transactions."

Conflicts of interest may arise between Eurocom Communications, B Communications, other companies within the Eurocom group and us that could be resolved in a manner unfavorable to us and result in reduced revenues and income.

Conflicts of interest may arise between B Communications, Eurocom Communications and us in a number of areas relating to our past and ongoing relationships. Areas in which conflicts of interest between B Communications, Eurocom Communications and us could arise include, but are not limited to, the following:

- Cross officerships, directorships and share ownership. The ownership interests of our directors in our ordinary shares could create, or appear to create, conflicts of interest when directors and executive officers are faced with decisions that could have different implications for the two companies. For example, these decisions could relate to the nature, quality and cost of services rendered to us by Eurocom Communications and B Communications, disagreements over the desirability of a potential acquisition opportunity or employee retention or recruiting. In addition, Eurocom Communications may take an opportunity for itself or preclude us from taking advantage of a corporate opportunity; and
-

Intercompany transactions. From time to time, Eurocom Communications, B Communications or other companies within the Eurocom group may enter into transactions with us or our subsidiaries or other affiliates. Although the terms of any such transactions will be established based upon negotiations between employees of such companies and us and, when appropriate, subject to the approval of our independent directors or a committee of disinterested directors and in some instances a vote of shareholders, the terms of any such transactions may not be as favorable to us or our subsidiaries or affiliates as may otherwise be obtained in arm's-length negotiations with unaffiliated third parties.

Risks Related to Our Ordinary Shares

Our share price has been volatile and may decline in the future.

The market price of our ordinary shares has been subject to significant price movements and could be subject to wide fluctuations in the future in response to factors such as the following, some of which are beyond our control:

- Quarterly variations in our operating results;
- Global economic conditions;
- Price movements in the market price of B Communications' and Bezeq's ordinary shares;
- Operating results that vary from the expectations of securities analysts and investors;
- Changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- Regulatory changes that impact pricing of services and competition in Bezeq's markets;
- Changes in market valuations of other communications companies;
- Announcements of technological innovations or new services by Bezeq or its competitors;
- Announcements by Bezeq or its competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- Changes in the status of Bezeq's intellectual property rights;
- Announcements by third parties of significant claims or proceedings against us or Bezeq;
- Additions or departures of key personnel;
- Future sales of our ordinary shares; and
- Stock market price and volume fluctuations.

Domestic and international stock markets often experience extreme price and volume fluctuations. Market fluctuations, as well as general political and economic conditions, such as a recession or interest rate or currency rate fluctuations or political events or hostilities in or surrounding Israel, could adversely affect the market price of our ordinary shares.

We have never paid cash dividends to our shareholders and have not adopted a dividend distribution policy.

We have never declared or paid cash dividends on our ordinary shares and have not adopted a dividend distribution policy. B Communications' indirect wholly-owned subsidiary, SP2, which directly holds Bezeq's shares and our principal source of revenues and income, is subject to limitations on the payment of dividends under the terms of the financing agreements entered into in connection with its acquisition of the controlling interest in Bezeq. You should not rely on an investment in our company if you require dividend income from your investments.

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We may in the future be classified as a passive foreign investment company, which will subject our U.S. investors to adverse tax rules.

There is a risk that we may be treated in the future as a "passive foreign investment company." Our treatment as a passive foreign investment company could result in a reduction in the after-tax return to the U.S. holders of our ordinary shares and may cause a reduction in the value of such shares. A foreign corporation will be treated as a passive foreign investment company for U.S. federal income tax purposes if either (1) at least 75% of its gross income for any taxable year consists of certain types of "passive income," or (2) at least 50% of the average value of the corporation's gross assets produce, or are held for the production of, such types of "passive income." For purposes of these tests, "passive income" includes dividends, interest and gains from the sale or exchange of investment property; and cash is considered to be an asset that produces passive income. If we are classified in the future as a passive foreign investment company for U.S. federal income tax purposes, highly complex rules would apply to U.S. shareholders owning ordinary shares. Accordingly, you are urged to consult your tax advisors regarding the application of such rules. United States residents should carefully read "Item 10E. Additional Information - Taxation, United States Federal Income Tax Consequences" for a more complete discussion of the U.S. federal income tax risks related to owning and disposing of our ordinary shares.

Risks Related to the Operations of Bezeq and Our Company in Israel

Political, economic and military instability in Israel may disrupt our operations and negatively affect our business condition, harm our results of operations and adversely affect our share price.

We and Bezeq are incorporated and based in the State of Israel and Bezeq derives substantially all of its revenues from markets within the State of Israel. As a result, political, economic and military conditions affecting Israel directly influence us. Any major hostilities involving Israel, a full or partial mobilization of the reserve forces of the Israeli army, the interruption or curtailment of trade between Israel and its present trading partners, or a significant downturn in the economic or financial condition of Israel could adversely affect our business, financial condition and results of operations.

Since the establishment of the State of Israel in 1948, Israel and its Arab neighbors have engaged in a number of armed conflicts. A state of hostility, varying from time to time in intensity and degree, has led to security and economic problems for Israel. In recent years, there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups. Also, during 2011, riots and uprisings in several countries in the Middle East and neighboring regions have led to severe political instability in several neighboring states and to a decline in the regional security situation. Such instability may affect the local and global economy, could negatively affect business conditions and, therefore, could adversely affect our operations. To date, these matters have not had any material effect on our business and results of operations; however, the regional security situation and worldwide perceptions of it are outside our control and there can be no assurance that these matters will not negatively affect us in the future. Ongoing violence between Israel and the Palestinians as well as tension between Israel and other countries in the Middle East may have a material adverse effect on our business, financial condition and results of operations.

Our results of operations may be negatively affected by the obligation of our personnel to perform military service.

Many of Bezeq's and our executive officers and employees in Israel are obligated to perform annual reserve duty in the Israeli Defense Forces and may be called for active duty under emergency circumstances at any time. If a military conflict or war arises, these individuals could be required to serve in the military for extended periods of time. Bezeq's operations could be disrupted by the absence for a significant period of one or more of its executive officers or key employees or a significant number of other employees due to military service. Any disruption in Bezeq's operations could adversely affect its business.

Bezeq may be restricted in the conduct of its operations during periods of national emergency, which could negatively affect its business operations.

During periods of national emergency, the Minister of Communications and other governmental authorities may issue various instructions regarding the use of Bezeq's network, including the use of the network by the Israeli security forces. In addition, the Israeli Equipment Registration and IDF Mobilization Law, 1987 permits the registration, taking and use of engineering equipment and facilities by Israel's Defense Forces. These actions could adversely affect Bezeq's business operations.

Our operating results may be adversely affected by significant fluctuations of the NIS against foreign currencies.

We report our financial results in NIS. Bezeq receives payments in NIS for most of its sales. As a result, fluctuations in rates of exchange between NIS and the U.S. dollar may affect our operating results and financial condition. In addition, when the Israeli inflation rate exceeds the rate of the NIS depreciation against foreign currencies, some of our NIS expenses increase to the extent of the difference between the rates. A significant disparity of this kind may have a material adverse effect on our operating results.

From time to time, the Bezeq Group engages in currency hedging transactions to reduce the impact on its cash flows and results of operations of currency fluctuations. The Bezeq Group recognizes freestanding derivative financial instruments as either assets or liabilities in the statements of financial position and it measures those instruments at fair value. However, accounting for changes in the fair value of a derivative instrument, such as a currency hedging instrument, depends on the intended use of the derivative instrument and the resulting designation. For derivative instruments that are not designated as cash flow hedges, changes in fair value are recognized in our income statement without any reference to the change in value of the related budgeted expenditures. These differences could result in fluctuations in our reported net income on a quarterly basis.

As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we may follow certain home country corporate governance practices instead of certain NASDAQ requirements.

As a foreign private issuer whose shares are listed on the NASDAQ Global Select Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Stock Market Rules. As a foreign private issuer listed on the NASDAQ Global Select Market, we may follow home country practice with regard to, among other things, the composition of the board of directors, compensation of officers, director nomination process and quorum at shareholders' meetings. In addition, we may follow home country practice instead of the NASDAQ requirement to obtain shareholder approval for certain dilutive events (such as for the establishment or amendment of certain equity-based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company). A foreign private issuer that elects to follow a home country practice instead of NASDAQ requirements must submit to NASDAQ in advance a written statement from an independent counsel in such issuer's home country certifying that the issuer's practices are not prohibited by the home country's laws. In addition, a foreign private issuer must disclose in its annual reports filed with the Securities and Exchange Commission each such requirement that it does not follow and describe the home country practice followed by the issuer instead of any such requirement. Accordingly, our shareholders may not be afforded the same protection as provided under NASDAQ's corporate governance rules.

Our shareholders generally may have difficulties enforcing a U.S. judgment against us, our executive officers and directors and some of the experts named in this annual report, or asserting U.S. securities law claims in Israel.

We are incorporated in Israel and all of our executive officers and directors named in this annual report reside outside the United States. Service of process upon them may be difficult to effect within the United States. Furthermore, all of our assets and most of the assets of our executive officers and directors and some of the experts named in this annual report are located outside the United States. Therefore, a judgment obtained against us or any of them in the United States, including one based on the civil liability provisions of the U.S. federal securities laws, may not be collectible in the United States and may not be enforced by an Israeli court. It also may be difficult for you to assert U.S. securities law claims in original actions instituted in Israel.

Provisions of Israeli law, the licenses of Bezeq and our articles of association may delay, prevent or make difficult an acquisition of our company, which could prevent a change of control and, therefore, depress the price of our shares.

Following our acquisition of the controlling interest in Bezeq, we and our shareholders are required to comply with the Communications Law, the Communications Order and regulations promulgated by the Ministry of Communications.

Pursuant to the Communications Order, we were required to obtain the prior written consent of the Prime Minister of Israel and the Israeli Minister of Communications in order to acquire the controlling interest in Bezeq. Under the Communications Order, no person may acquire, directly or indirectly, the ability to exercise “significant influence” over Bezeq or 5% or more of any particular class of means of control in Bezeq, nor may any person, together with any other person, appoint the general manager of Bezeq or cause the election or appointment of any director of Bezeq, without the prior written consent of the Prime Minister of Israel and the Israeli Minister of Communications. Subject to certain exceptions, prior written approval of such Ministers is also required to increase the holdings or other rights in excess of those determined in the initial approval, including by means of an agreement (including a voting agreement). Furthermore, under the Communications Order, no person may transfer control, “significant influence” or means of control in Bezeq to another, if, as a result of the transfer, the holdings of the transferee would require approval pursuant to the Communications Law or Communications Order and the transferee is not in possession of the requisite approval. For the foregoing purposes, “significant influence” means the ability to significantly influence the activity of a corporation, whether alone or together with or through others, directly or indirectly, as a result of holding means of control in that corporation or in another corporation, including ability derived from the corporation’s articles of association, a written, oral or other kind of agreement, or from any other source, excluding solely as a result of the performance of an office holder’s duties in the corporation. In this context, holding 25% of our means of control is presumed to confer significant influence. ”Means of control” means the right to vote at a general meeting of the company, to appoint a director or general manager of the company, to participate in the profits of the company or a share of the remaining assets of the company after payment of its debts upon liquidation.

Israeli corporate law regulates mergers, requires tender offers for acquisitions of shares above specified thresholds, requires special approvals for transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders, including Israeli shareholders and shareholders whose country of residence does not have a tax treaty with Israel exempting such shareholders from Israeli tax. For example, Israeli tax law does not recognize tax-free share exchanges to the same extent as U.S. tax law. With respect to mergers, Israeli tax law allows for tax deferral in certain circumstances but makes the deferral contingent on the fulfillment of numerous conditions, including a holding period of two years from the date of the transaction during which sales and dispositions of shares of the participating companies are restricted. Moreover, with respect to certain share swap transactions, the tax deferral is limited in time, and when the time expires, tax then becomes payable even if no actual disposition of the shares has occurred. These provisions of Israeli law may delay, prevent or make difficult an acquisition of our company, which could prevent a change of control and therefore depress the price of our shares. For additional discussion about some anti-takeover effects of Israeli law, see “Item 6C. Directors, Senior Management and Employees –Board Practices – Approval of Related Party Transactions under Israeli Law” and Item 10E. “Taxation -Israeli Tax Considerations.”

The rights and responsibilities of our shareholders are governed by Israeli law and differ in some respects from those under Delaware law.

Because we are an Israeli company, the rights and responsibilities of our shareholders are governed by our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in a Delaware corporation. In particular, a shareholder of an Israeli company has a duty to act in good faith towards the company and other shareholders and to refrain from abusing his, her or its power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law provides that these duties are applicable to shareholder votes on, among other things, amendments to a company’s articles of association, increases in a company’s authorized share capital, mergers and interested party transactions requiring shareholder approval. In addition, a shareholder who knows that it possesses the power to determine the outcome of a shareholders’ vote or to appoint or prevent the appointment of a director or executive officer in the company has a duty of fairness towards the company. However, Israeli law does not define the substance of this duty of fairness. Because Israeli corporate law has undergone extensive revisions in recent years, there is little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

ITEM 4. INFORMATION ON THE COMPANY

A. History and Development of the Company

We were incorporated under the laws of the State of Israel in April 1992 under the name Euronet Golden Lines (1992) Ltd. In June 1999 we changed our name to Internet Gold - Golden Lines Ltd. We are a public limited liability company under the Israeli Companies Law 1999 and operate under this law and associated legislation. Our registered offices and principal place of business are located at 2 Dov Friedman Street, Ramat Gan 52503, Israel, and our telephone number is +972-72-924-0000. Our address on the Internet is www.igld.com. The information on our website is not incorporated by reference into this annual report on Form 20-F.

We are a leading communications group in Israel. Our principal subsidiary, B Communications, is the controlling shareholder of Bezeq (TASE:BZEQ), Israel's largest telecommunications provider. Since B Communications' initial public offering in October 2007, its ordinary shares have been listed on NASDAQ Global Market (symbol: BCOM) and the TASE, and since January 1, 2011 its ordinary shares are listed on the NASDAQ Global Select Market. We currently own 78.11% of the ordinary shares of B Communications. B Communications maintains a website at b.communications.co.il. The information on B Communications' website is not incorporated by reference into this annual report on Form 20-F.

We began providing Internet access services in 1996, and began offering broadband services in 2001 and traditional voice services in 2004. As part of our internal restructuring in 2006, we transferred our broadband and traditional voice services businesses, which we refer to in this annual report as the legacy communications business, to B Communications (formerly named 012 Smile.Communications), and our media operations to Goldmind (formerly named 012 Smile.Media). During 2010 and 2011 we have sold all of our media assets.

Legacy Communications Business

Prior to January 2010, our principal subsidiary, B Communications (then named 012 Smile.Communications Ltd.), was a communication services provider in Israel that provided a wide range of broadband and traditional voice services.

On October 25, 2009, B Communications entered into a share purchase agreement to acquire the controlling interest in Bezeq, Israel's largest telecommunications provider, from Ap.Sb.Ar. Holdings Ltd.

As part of its acquisition of the controlling interest in Bezeq, on November 16, 2009, B Communications entered into an agreement to sell its legacy communications business (excluding certain retained indebtedness and liabilities) to a wholly-owned subsidiary of Ampal-American Israel Corporation (NASDAQ: AMPL), or Ampal, for NIS 1.2 billion (approximately $338 million). The sale of B Communications' legacy communications business to Ampal was completed on January 31, 2010, effective as of January 1, 2010. In connection with the sale of our legacy communications business, substantially all of the executive officers and employees of B Communications as of the closing of the transaction were hired by Ampal.

In connection with our decision to withdraw from the Internet media business, in April 2011, we sold our Internet portal, zahav.ru, our children's portal, Tipo, and the Vgames game website to Teletel Communication Channels Ltd., a wholly owned subsidiary of Walla! Communications Ltd., an Israeli company controlled by Bezeq, whose shares are listed on the TASE and which provides Internet and portal services. Under the agreement with Teletel Communication Channels Ltd. we received consideration of NIS 2.8 million (plus VAT) plus NIS 700,000 of advertising space on Walla's portal. In 2010 Goldmind had total revenues of NIS 75 million ($ 21 million) and EBITDA of NIS 3.5 million ($1 million).

In December 2010, we sold our Internet eCommerce operations activity to Best-Buy Marketing Chains for NIS 8.35 million (plus VAT) plus NIS 150,000 worth of advertising space. In addition, in January 2011, we sold our "Start" Internet operation for NIS 2.25 million (plus VAT). In January 2011, we also sold our holdings in "Seret," a movie and entertainment information website in Israel for 100,000 in addition to a return of a shareholders loan. In August 2011, we also sold our holdings in "Nirshamim," a Study information website in Israel for NIS 800,000.

Acquisition of the Controlling Interest in Bezeq

On April 14, 2010, B Communications completed the acquisition of 30.44% of Bezeq's outstanding shares from Ap.Sb.Ar. Holdings Ltd. for an aggregate cash purchase price of approximately NIS 6.5 billion and became the controlling shareholder of Bezeq. The Bezeq interest was directly acquired by an indirect wholly-owned subsidiary of B Communications. The transaction was completed after all conditions in the agreement were met, including receipt of the approval of the Prime Minister of Israel and the Israeli Minister of Communications (including the grant of control permits) and the Israeli Antitrust Commissioner. In accordance with the terms of the transaction, effective as of the closing of the acquisition, we designated seven directors to replace the Apax-Saban-Arkin Group's representatives on Bezeq's 13 person Board of Directors. We began consolidating Bezeq's financial results into our financial statements effective as of the closing of the acquisition and began reporting the consolidated results in our 2010 second quarter earnings release. As of April 30, 2012, we hold a 31.05% ownership interest in Bezeq.

Bezeq is the principal provider of communications services in Israel. Bezeq and its subsidiaries implement and provide a broad range of telecommunications operations and services, including domestic fixed-line, cellular, Internet services, international communication services, multi-channel television, satellite broadcasts, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, television and radio broadcasts, and supply and maintenance of equipment on customer premises (such as network endpoint services). Bezeq, which was established as a government company in 1980, became a public company in 1990 and its shares are traded on the TASE.

Bezeq has the following four principal areas of operation:

- Bezeq – domestic fixed-line communications. This segment primarily includes Bezeq's operation as a domestic operator, including fixed-line telephony services, Internet services, transmission services and data communications.

- Pelephone – cellular telephone. Cellular mobile telephone services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems.

- Bezeq International – Internet, international communications and network endpoint, or NEP, services. Bezeq International is an Internet service provider, or ISP, and also provides international communications services and NEP services.

- DBS - Provides multi-channel broadcast and value added services via satellite.

In view of the decision in 2009 of the Israeli Supreme Court not to approve the merger of Bezeq and DBS, Bezeq ended its control over DBS and commencing August 21, 2009 it ceased consolidating the results of DBS into its financial statements and Bezeq accounts for its investment in DBS shares under the equity method.

Below are details of the holdings in Bezeq at December 31, 2011 and at March 30, 2012, and on a fully diluted basis at April 30, 2012, assuming exercise of all the options granted to employees and managers of the Bezeq Group at April 30, 2012.

	Holding %		
Shareholders	At December 31, 2011	At March 30, 2012	With full dilution at April 30, 2012 (1)
B Communications (through SP2)	31.10 %	31.08 %	31.05 %

The public	68.90 %	68.92 %	68.95 %

(1) Full dilution calculation assumes that all outstanding options are exercised pursuant to the Stock Appreciation Rights (SAR) mechanism of the 2007 Stock Option Plan for Managers and Senior Employees in the Bezeq Group and the 2007 Employee Stock Options Plan in the Bezeq Group. This assumption is theoretical as under the terms of the plans the offerees who exercise their options will not receive the number of shares underlying them, but as a cashless exercise they will receive the number of shares that reflect the financial benefit embodied in the options.

Permit to Control Bezeq Granted to Members of the Eurocom Group

As part of B Communications' acquisition of the controlling interest in Bezeq, we, SP2, SP1 and other members of the Eurocom group applied for authorization to control Bezeq, pursuant to the Communications Law and Communications Order. On April 13, 2010, the control permit was granted subject to the condition that SP2 continues to be controlled exclusively by the other parties to the control permit, referred to as the Companies' Control Permit. Concurrently, a separate control permit was also granted to Messrs. Shaul Elovitch and Yossef Elovitch, our controlling shareholders, referred to as the Individuals' Control Permit.

According to the Companies' Control Permit, the parties must hold not less than 30% of any type of means of control of Bezeq and SP2. In February 2011, the Prime Minister and Minister of Communications gave approval for such percentage to reach 29% in the event of dilution resulting from the exercise of stock options by Bezeq employees, for a period of six months commencing from the date such holdings fall below 30%. B Communications' subsidiary which owns the Bezeq shares is deemed to hold the Bezeq shares directly notwithstanding that the Bezeq interest is recorded in the name of a trust company wholly-owned by Bank Hapoalim, which was granted a lien over the Bezeq shares that were purchased from Ap.Sb.Ar. Holdings Ltd and held by SP2 as a security for the repayment of the NIS 4.6 billion loan (which debt was reduced to NIS 3 billion (approximately $0.8 billion) at December 31, 2011) provided by Bank Hapoalim and other banking and financial institutions, referred to as the Lending Parties, for the funding of the acquisition of the Bezeq interest.

In accordance with the Companies' Control Permit, SP2, which holds the Bezeq shares is required to notify the Prime Minister of Israel and Israeli Minister of Communications of any changes in the composition of its board of directors every six months and if the change represents half or more of the members of the board of directors, within 30 days of the change. The parties to the Companies' Control Permit are also required to notify such Ministers of any "Exceptional Holdings" immediately upon becoming aware of such event. Such parties are also required to notify such Ministers in the event a shareholder becomes a "Principal Shareholder" and regarding any change in the holdings of a Principal Shareholder within 48 hours of becoming aware of such change. The terms "Exceptional Holdings" and "Principal Shareholder" are defined in the Communications Order and in our Articles of Association and are described below in Item 10B "Additional Information - Memorandum and Articles of Association - Rights Attached to Shares - Exceptional Holdings; Principal Shareholders."

The parties to the Companies' Control Permit may not transfer means of the control in Bezeq at a rate which requires the approval of the Prime Minister of Israel and Israeli Minister of Communications under the Communications Order, without such Ministers prior written approval. The foregoing includes a transfer of the Bezeq interest in one transaction or a series of transactions, by one party or together with the other parties to the Companies' Control Permit or the parties to the Individuals' Control Permit. However, the parties may transfer the means of control of Bezeq among themselves, subject to compliance with certain conditions set forth in the Companies' Control Permit

The Lending Parties undertook to comply with the provisions of the Communications Law, Communications Order and the lien permit granted to them relating to their rights under the credit agreement entered into among SP2 and the Lending Parties and the realization of the lien. The rights granted to the Lending Parties are deemed to be an encumbrance of collateral and the Lending Parties may not exercise rights pursuant to the means of control except as set forth in the lien permit. The lien permit was granted exclusively to the Lending Parties and any change in the composition of the Lending Parties or a modification of the credit agreement entered into among SP2 and the Lending Parties requires the prior written consent of the Prime Minister of Israel and Israeli Minister of Communications. The appointment of a receiver, on any grounds whatsoever, with respect to the holdings in SP2 or SP2's holdings in Bezeq, will constitute grounds for canceling the lien permit. The violation of the lien permit by the Lending Parties will constitute grounds for canceling such permit and for the appointment of a receiver and trustee, in accordance with the terms of such permit.

According to the Companies' Control Permit, SP2 must at all times be held by an "Israeli Party," as defined in the Communications Order, to the following extent:

- At least 19% of each of the means of control of SP2 must be held by an Israeli Party at all times; or
- At least 19% of the rights to vote at the general meeting of shareholders of SP2 and the rights to appoint directors of SP2 must be held by an Israeli Party at all times; and

- The right to appoint at least one-fifth of the directors in Bezeq and Bezeq's subsidiaries and not less than one director in each such company will be held by an Israeli Party at all times, provided that the percentage of the Israeli Party's direct or indirect shareholdings in Bezeq is not less than 3% of any of the means of control of Bezeq. Indirect shareholdings will be calculated as the product of the Israeli Party's lowest rate of holdings in each of the means of control in SP2, multiplied by the percentage of the holdings of the parties to the control permit in each of the means of control in Bezeq.

The Prime Minister of Israel and Israeli Minister of Communications have determined that we and B Communications are deemed to be "Israeli Parties," so long as we and B Communications are controlled by a citizen and resident of Israel and that the ownership interest of Messrs. Shaul Elovitch and Yossef Elovitch in Internet Gold does not fall below 50.0% and our ownership in B Communications does not fall below 50%. In accordance with such approval, we and B Communications may only transfer our holdings in Bezeq to an Israeli Entity, subject to all approvals required by law.

The parties to the Companies' Control Permit may not be controlled by any country or government company or a company controlled by a government company. The Companies' Control Permit will terminate if the foregoing condition ceases to exist with respect to any such party without the approval of the Prime Minister of Israel and Israeli Minister of Communications. Such Ministers may authorize a government company to hold an interest in any such party, provided that the government company's aggregate direct or indirect holdings in Bezeq do not exceed 5% of any type of means of control of Bezeq and that it does not control such party.

In the event the Prime Minister of Israel and Israeli Minister of Communications find that the information they were provided is incorrect, that there has been a material change in the details provided by the parties to the Companies' Control Permit which justifies its cancellation, or such parties failed to submit a required report, and such Ministers determine that there is probable cause to believe that the provision of the services that Bezeq is required to provide pursuant to its general license (including basic telephone, infrastructure, transmission and data transmission services and ancillary services) or the grounds for determining that any such service has been harmed, such Ministers may take action to cancel the Companies' Control Permit. Upon its cancellation, all the shareholdings purchased under the Companies' Control Permit will be deemed "Exceptional Holdings," as described above.

The Companies' Control Permit also authorizes an interested party in B Communications and our company that is not a party to the Companies' Control Permit or the Individuals' Control Permit to hold means of control in Bezeq, provided that such interested party does not hold more than 15% of any type of means of control of B Communications and our company. The foregoing authorization is subject to the condition (among others) that the percentage of holdings of the parties to the Companies' Control Permit in B Communications, and of Eurocom Communications' holdings in our company exceed 50% of the means of control in each of such companies at all times. We and B Communications are required to notify the Prime Minister of Israel and Israeli Minister of Communications of the shareholdings of any such interested party.

The provisions of the Companies' Control Permit are subject to the terms of the Communications Order and Communications Law, as they may be amended from time to time.

B. Business Overview

Since April 14, 2010, we, through our B Communications subsidiary have been the controlling shareholder of Bezeq (TASE:BZEQ), Israel's largest telecommunications provider.

The Israeli Communications Industry

The communications industry around the world and in Israel has developed rapidly. The technology and corporate structure and regulations governing the communications industry in Israel has undergone and continue to be subject to constant changes. A number of communications groups operate in the Israeli communications market on the basis of cooperative marketing among a number of companies and/or among companies with common ownership for the supply of comprehensive communications service packages, thus utilizing the marketing and operational advantages inherent in such a structure.

Government Regulations

The Israeli communications industry is regulated and controlled by the Israeli Ministry of Communications and to a lesser degree by other governmental authorities. Bezeq is subject to government supervision and regulation relating to, among other things, licensing, determining permitted areas of activity, determining tariffs, operation, competition, environmental matters, payment of royalties, obligation to provide universal service, ability to hold its shares, relationships between Bezeq and its subsidiaries and prohibitions as to the termination or restriction of its services (which may force Bezeq to provide services at a loss. Bezeq was declared a monopoly in its main fields of activity, and is also subject to control and restrictions under the Antitrust Law, 5748-1988, or the Antitrust Law. This supervision and regulation at times lead to governmental intervention. Bezeq's business and operations could be adversely affected by decisions of regulators, in particular the Ministry of Communications as well as changes in laws, regulations or government policy affecting its business activities. Further risks and uncertainties result from the fact that changes in such laws, regulations or government policies may not be adopted or implemented in the manner that Bezeq expects and may be further amended, interpreted or enforced in an unexpected manner or in a manner adverse to Bezeq's business and results of operations.

Bezeq was declared a provider of essential telecommunications services under the Communications Order (see below). By virtue of that declaration, Bezeq is required to provide certain types of services and may not interrupt its provision of such services or narrow them. Among these services are basic telephone services, infrastructure services, transmission services and data communication services including, interconnect, and other services listed in the schedule to the Communications Order.

Under Israeli regulations, an application may be filed by competitors of Bezeq for a special general domestic license to provide landline services, which does not involve an obligation to provide services to the entire Israeli public, as is required under Bezeq's general license. 012 Smile Telecom (now owned by Partner), Cellcom and Partner, the principal competitors of Bezeq in this field, have all been granted such licenses. Unlike Bezeq, Partner, Cellcom and 012 Smile Telecom are entitled to offer service packages that combine cellular and landline services, which give them a competitive advantage over Bezeq.

On February 13, 2011, a sub-committee of the Israeli Parliament (the Knesset) for Economic Affairs, or the Knesset Economic Affairs Committee, approved regulations for the establishment of an advisory committee to the Minister of Communications. The role of the advisory committee will be to recommend the approval of exemptions from or delays in the provision of the universal services by license holders upon extraordinary circumstances. The advisory committee has not yet established its work arrangements.

On October 11, 2011, Bezeq was notified by the Israeli Antitrust Commissioner that he was considering the issuance of a finding that it violated the provisions of Section 29A of the Antitrust Law by, among other things, not providing infrastructure and transmission services for telephony and Internet services (domestic operator) to its competitors, Cellcom Israel Ltd., or Cellcom, and Partner. In October 2010, Bezeq started to provide infrastructure and transmission services to competing telecommunications operators.

The Communications Order

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

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

- Transfer or acquisition of control in Bezeq requires the approval of the Ministers by means of a Control Permit. The Control Permit establishes the minimum holding percentage in each of the means of control in Bezeq by the holder of the Control Permit where a transfer of shares or an issuance of shares by Bezeq, as a result of which the percentage of ownership of the Control Permit holder will fall below the minimum percentage, is prohibited without the prior approval of the Ministers, subject to permitted exceptions (including, an issuance to the public under a prospectus, or sale or private placement to institutional investors).

- Holdings not approved in compliance with the Communications Order will be considered "exceptional holdings" and any exercise of a right by virtue of exceptional holdings will not be valid. The Communications Order also contains provisions authorizing the Ministers and Bezeq to apply to the courts with an application for the enforced sale of exceptional holdings.

- A duty to report to the Ministers upon demand is imposed on Bezeq with respect to any information on matters relating to provision of an essential service.

- 75% of the members of the Board of Directors of Bezeq must be Israeli citizens and residents who have a security clearance as determined by the General Security Service.

- The Chairman of the Board of Directors of Bezeq, the external directors, the chief executive officer, the deputy chief executive officer and other office holders in Bezeq as listed in the Communications Order, must be Israeli citizens and residents and have a security clearance appropriate to their functions.

- Nationality requirements are established for the controlling shareholder in Bezeq: an individual must be an Israeli Entity (as defined in the Communications Order); a corporation must be incorporated in Israel, the center of its business must be in Israel, and an Israeli Entity must hold at least 19% of the means of control of such company.

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

- Provisions were established for the matter of protection of computerized systems and the purchase of hardware and software.

- Certain actions of Bezeq require the approval of the Minister of Communications, including voluntary liquidation, a settlement or arrangement between Bezeq and its creditors, a change or reorganization of the structure of Bezeq and a merger or split of Bezeq.

The regulations affecting the Bezeq Group are described in the sections of this annual report relating to each of the operating segments of Bezeq.

Changes in the Regulatory Environment

The policy of the Ministry of Communications to advance competition in the communications market was outlined in the Gronau Report and in the letter of the then Minister of Communications dated August 13, 2008, concerning adoption of the report, or the Competition Policy Documents. The Competition Policy Documents established a number of principles relating to the Group's activities, which include:

- Wholesale market of fixed-line infrastructure. The wholesale market in the fixed-line segment must be developed, with the prime goal being dismantling it into sections. Owners of universal infrastructures (Bezeq and HOT) will be required to offer all services wholesale (e.g. resale – wholesale purchase at a reduced price from the owner of the infrastructure by a communications operator and retail marketing to end users), and the leasing of access sections to competitors (Unbundling Local Loop), which for reasons of technological applicability it was determined would apply at this stage only to Bezeq). It was also determined that the Ministry of Communications would start the preparation of the regulatory and pricing basis required for establishing the wholesale market. Among other things, the Hayek Committee was established for this purpose.

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

- Flexibility in the approval of alternative tariff packages for Bezeq.
- Issuance of MVNO licenses to virtual cellular operators.
- Structural separation. It was decided to enforce structural separation on the HOT Telecom and to leave the structural separation in Bezeq Group as long as there are only two companies that own a nationally-deployed fixed-line infrastructure (nevertheless, the license of HOT Telecom was amended in June 2009 and exceptions made to the structural separation obligation between Hot Telecom and HOT Broadcasts).
- Entry of cellular operators into the international telephony market.
- Decrease the rate of royalties. A gradual decrease in the rate of royalties applicable to license-holders was decided upon, subject to their eventual cancellation.

The Hayek Committee

On March 28, 2010, the Ministers of Communications and Finance appointed the Hayek Committee to review and revise the structure of Bezeq's tariffs and to set wholesale fixed-line communications service tariffs. The Hayek Committee was requested to make recommendations regarding the base level of telecommunications tariffs and how they should be calculated, a tariff control mechanism, tariff updates including an efficiency factor and mechanisms for the prevention of cross-subsidization among the various services, based on the cost of the services. The committee also discussed structural separation in the communications market, the issue of tariff control – its format and its necessity and the proposed project to utilize the infrastructure of the Israel Electric Corporation, or IEC, to provide communication services. On October 4, 2011, the Hayek Committee published its report with final recommendations. The Committee's recommendations are subject to the approval of the Ministers of Communications and Finance. The main recommendations in the report are as follows:

- Development of a wholesale market. Holders of a Domestic Carrier General License, or Carrier License, (as of December 31, 2011, only Bezeq and HOT held such licenses) should be required to provide service and allow the use of their infrastructure to enable other license-holders to provide services to end-users. Broadband access services should be provided immediately, in a manner that will enable a service provider that does not have its own infrastructure to manage the service. The report recommends that Carrier License holders enter into agreements with other license-holders for the use of their infrastructure. The regulator will be permitted to force changes in these agreements should they fail to comply with the standards listed in the recommendations.
- The committee also recommended that Carrier License holders regularly publish details of the use of their existing infrastructures by other license holders, in accordance with the requirements of the regulator (with certain exceptions to be defined by the Ministry of Defense). Additionally, the committee recommended that the license holders deposit bank guarantees in the amount of NIS 200 million to guarantee that a wholesale market is maintained (parts and portions of the guarantee may be forfeited as determined by the regulator) and that the Carrier License holders' managers will bear personal liability if they fail to allow competitive use of their company's infrastructures by other license-holders. The committee also recommended that its recommendations be included in legislation that will also contain sanctions should the Carrier License holders fail to comply with the wholesale market regulations.
- Setting prices. Until the regulator sets the tariffs, the price of each wholesale service should be uniform, irrespective of the consumer's characteristics; retail services sold by holders of a Carrier License, including Internet infrastructure on all bandwidths and the sale of call minutes, should be sold to other license holders at a price that is no greater than 75% of the average retail price that Bezeq offered to private customers during the period

July-September 2011. This arrangement should apply for six months from such time as the Minister of Communications approves the regulations. The Minister of Communications may extend this period by an additional six months.

The prices of these services should be determined as a maximum price and they should be calculated based primarily on the cost of the services. The regulator may determine that the prices of these services should not be set on a cost basis if he believes that the use of a different calculation will not affect the competition in this sector. The rate of return on the capital will be dynamic, based on the Carrier License holders' risk levels in any given year. Prices should be reviewed once every three years. The regulator's involvement may be eliminated in due course if it is convinced that a wholesale market has developed and that competition in the sector has significantly improved.

- Abolishment of structural separation. Bezeq's Carrier License states that it must maintain structural separation between itself and its Pelephone, Bezeq International, DBS and Bezeq On Line subsidiaries. This framework includes: (i) the complete separation of the management of these subsidiaries, including their business systems, financial systems and marketing systems; (ii) the complete separation of their assets; (iii) a prohibition on Bezeq hiring employees of a subsidiary and vice versa; (iv) restrictions on the appointment of a Bezeq employee (other than the chairman of the board) as a director of a subsidiary; and (v) a prohibition on the transfer of commercial information to a subsidiary (including in relation to Bezeq). Such structural separation limitations have placed the Bezeq Group at a disadvantage compared with other communications groups that are not subject to such far-reaching limitations and are able to deploy mergers and integrated operations. These limitations have resulted in high management overhead and a continuing decline in competitiveness.

The committee recommended that the current obligation for structural separation with respect to fixed line and other telecommunications services be abolished after the passage of six months from the earlier of (i) the date on which the agreements between the Carrier License holders for the use of their infrastructure are signed; or (ii) date on which Carrier License holders begin to supply wholesale services pursuant to such agreements (except for structural separation in multi-channel TV which will be abolished after TV broadcasting over the Internet becomes possible). If no such agreement is achieved, the structural separation will be abolished when the tariffs are set, as aforementioned.

All the companies should be prohibited from transferring information between the wholesale and retail sectors to allow market participants to offer a full range of telecommunication services without any structural separation restrictions. If a wholesale market does not becomes operational within 24 months of the publication of the committee's recommendations, the regulating body should take action to implement structural separation between the infrastructure of the Carrier License holders and the services rendered to end customers.

- Retail price control. The regulator should revise the maximum tariff from time to time and the price should be calculated based on the cost principle; the maximum price will be deregulated by setting tariffs in regulations, and moving over to price control under Section 17 of the Communications Law after the regulator is persuaded that competition in this branch makes this possible. After the deregulation of prices and the removal of structural separation, the regulating body should consider cancelling the fixed usage fees collected by Bezeq.

- Venture for telecommunications over IEC infrastructure. The committee gave considerable importance to advancing the activity of a telecommunications company which is expected to operate on the infrastructure of the IEC and believes that, with respect to the supply of wholesale services, the regulations to be applied to the entity that emerges from this initiative should be similar to the regulations applicable to the other Carrier License holders.

- Consumer perspectives. The telecommunications companies shall allow all consumers to benefit from all the price packages that they offer; obligations should apply and action shall be taken to inform customers and advertise prices, and the information must be accessible to consumers.

At this stage, Bezeq is unable to estimate the repercussions of the report on its business performance, in part due to the dependence on way in which the recommendations are adopted and implemented.

Proposal for a new communications authority

In July 2010, the Ministry of Communications distributed a memo, The Israel Communications Authority Law 5770-2010, concerning the establishment of a communications authority, which would become the main regulatory body for telecommunications and for broadcasting in Israel and would hold the powers now held by the Ministry of Communications, the Second Television and Radio Authority, the Second Authority Council and the Council for Cable and Satellite Broadcasts.

Other limitations on prices and offering benefits to Bezeq Group companies and joint ventures

Other limitations on cooperative ventures between Bezeq and its subsidiaries arise from various provisions under the antitrust laws and conditions established by the Antitrust Commissioner in approvals of mergers between Bezeq and Group companies. Such limitations include a prohibition against discrimination in favor of companies within the Bezeq Group when providing certain services and the requirement to provide services equally to all and at a uniform tariff.

Control of Bezeq’s Tariffs

The tariffs for Bezeq’s controlled services (telephony and others) which are fixed in regulations promulgated under the Communications Law were updated so that on average, Bezeq's controlled tariffs will erode in real terms. The Competition Policy Documents state that as long as the Bezeq Group's market share is higher than 60%, tariff control will continue in a format of fixing binding tariffs. The recommendations of the Hayek Committee for reviewing and revising the structure of Bezeq's tariffs, if adopted, could change the mechanism for fixing and updating the tariffs.

Under the Communications Law, if tariffs are fixed for controlled services, the Minister of Communications may, with the consent of the Minister of Finance, approve the request made by a licensee for an alternative payment package for a service package. The approval mechanism was simplified in December 2010 as part of the Arrangements Law, so that Bezeq can offer an alternative payment package after the period defined in the law unless either Minister of Communications or Minister of Finance announces their objection. The Competition Policy Documents state that an alternative payment package will be approved only of it is worthwhile for 30% or more of the subscribers who consume the services offered in the package and the smaller the market share of the Bezeq Group in fixed-line telephony, the higher the maximum discount rate permitted in an alternative payment package can be.

On February 9, 2012, the Ministry of Communications informed Bezeq of its objection to an alternative payment package that had been submitted for its approval, on the grounds that it does not comply with the conditions stipulated in the Gronau Report and with respect to prices of NDSL, a subscriber's line that provides high-speed access by means of ISPs only, or NDSL. Bezeq submitted its position in opposition to the objections and argued that the package meets the conditions stipulated in the Gronau Report.

Under the Communications Law, a license holder can demand reasonable payment for a telecommunications service for which payment is not fixed. Bezeq sets the tariffs for these types of services.

On July 3, 2011, Bezeq received a letter from the Director General of the Ministry of Communications concerning the price of its broadband Internet access services. In the letter, the Director General contended that the price changes by Bezeq were inconsistent with the provisions of its general license and that Bezeq should correct this. Further to the request of the Director General, Bezeq informed the Ministry that it would revise the price of Internet access infrastructure for new subscribers for its joint service bundles (through Bezeq and through ISPs) as well as for new subscribers who purchase infrastructure services separately.

Once every few years Bezeq's controlled tariffs are reviewed by a public committee and Bezeq is exposed to material changes in its tariff structure and tariff levels. The review mechanism for the controlled tariffs, as defined in the regulations, results in a real average erosion of the tariffs over time. Control of the tariffs creates or could create difficulties for Bezeq in providing an appropriate and competitive response to changes in the market and in offers of competitive prices on short notice. In addition, the restrictions on granting discounts on tariffs limit Bezeq’s ability to participate in certain tenders.

Service Packages

Pursuant to a policy paper published by the Minister of Communications in 2004, Bezeq was granted a permit to market joint service packages by means of an amendment to Bezeq's Carrier License. The amended license stated that after Bezeq's market share in a particular segment (private or business) falls below 85%, it will be allowed to market joint packages of services with its subsidiaries in the same segment. Bezeq's market share in the private sector (according to the method of calculation determined by the Ministry of Communications) fell below 85% in the private sector in 2008, and fell below 85% in the business sector in September 2009. Following such declines, in May 2010 Bezeq was permitted to offer private subscribers joint packages of services with its subsidiaries, subject to approvals by the Ministry of Communications and other conditions prescribed in Bezeq's Carrier License, including:

- The service packages must be able to be unbundled, meaning that a service included in a package will be offered separately and on the same terms; and

- At the time a request for approval of a service packages is submitted, there must be a group of services in similar format being marketed to a private subscriber as a package by a license-holder who is not a subsidiary of Bezeq, or there is a group that includes license-holders who provide a private subscriber with all the services included in the joint service packages.

Joint service packages marketed by Bezeq's subsidiaries and which include the services of Bezeq are also subject to similar limitations, including unbundling (except for a service package marketed by a subsidiary that contains only Bezeq's Internet infrastructure service).

These limitations, and in particular the unbundling obligation, which severely limits the Bezeq Group's ability to offer discounts on the components of a service package, place the Bezeq Group in a competitively inferior position compared to the competing communications groups, which are not subject to similar limitations in marketing joint service packages (other than a limitation on marketing a joint service packages by HOT-Net and other companies in HOT Group).

At present, Bezeq may market joint service packages to the private sector only. As Bezeq's market share in the business sector declined to below 85% in September 2009, Bezeq requested that the Ministry of Communications amend its Carrier License that it can market joint service packages to business customers. On February 3, 2011, the Ministry of Communications sent a draft amendment to the communications licenses of the Bezeq Group companies that will enable them to market joint service packages to the business sector under the same limitations. However, an amendment permitting the marketing of joint bundles to the business sector has not yet been signed.

Limitation on the exit penalty a license-holder may collect from a subscriber

On August 8, 2011, an amendment to the Communications Law came into effect, which impacts holders of Carrier Licenses and International Communications and Broadcast licenses. Under the amendment, exit fees cannot be collected from a subscriber whose average monthly bill is less than NIS 5,000 who entered into an agreement after the effective date of the amendment, nor can the subscriber be denied a benefit that he or she would have received had he or she not terminated the agreement. Commencing November 8, 2011, the amendment also applies to subscribers who entered into agreements before the amendment became effective and subsequently cancelled their agreements. Such subscribers are subject to a cancelation fee of up to 8% of their average monthly bill, multiplied by the number of months remaining to the end of the term of the commitment. In addition, a license-holder may not demand immediate payment of the balance for the terminal equipment in the event of cancellation of the agreement. This amendment resulted in an increase in the churn rate and in certain adjustments to the terms in the subscriber agreements in order to conform them to the amendment.

Cellular license-holders are regulated by provisions limiting the exit fee that may be collected from certain subscribers who terminate their agreement before the end of the commitment period to 8% of the subscriber's average monthly bill at the cancellation date. The Economic Affairs Committee is discussing a bill which would set this exit fee at 0%.

Consumer protection

Frequent changes in consumer legislation regularly affect the operations of Bezeq and its subsidiaries. Bezeq and its subsidiaries are subject, among other things, to the Consumer Protection Law, 5741-1981, or the Consumer Protection Law. Various amendments to the Consumer Protection Law have been enacted, which include providing consumers with the ability to cancel transactions and to disconnect from on-going services and requiring customers to give their express consent to continue transactions after the end of the term of the contract. In addition, a number of pending legislative proposals provide for additional amendments to the Consumer Protection Law and may affect the conduct of Bezeq and its subsidiaries with their subscribers.

On February 20, 2012, the Knesset Economic Affairs Committee approved the proposed Consumer Protection (provision of telephony service) bill, according to which a recorded message must inform the consumer if the waiting time for a human response for free telephony service under the Consumer Protection Law is likely to exceed three minutes and provide the consumer the choice to leave a message or wait. The proposed bill also specifies maximum periods of time for responding to the consumer.

Enforcement and financial sanctions

Several bills, sponsored by the government, are now pending in the Knesset, which seek to amend the Communications Law, the Protection of Privacy Law and the Antitrust Law with respect to the enforcement and the imposition of monetary penalties for violations of these laws and/or their regulations. If approved, these amendments may affect the way in which Bezeq and its subsidiaries manage their affairs.

In January 2011, an amendment to the Securities Law was enacted as part of the Law to Streamline Enforcement Procedures by the Securities Authority (Legislative Amendments), 2011. The amendment empowers the Israeli Securities Authority to impose fines and an administrative enforcement committee to impose administrative enforcement measures for violations of certain provisions of the Securities Law. Subsequently, on February 16, 2012, Bezeq's board of directors approved internal procedures that address internal enforcement of the provisions of the law, mainly with respect to prohibition of the use of inside information, the obligation to publish periodic and immediate reports, and agreement with related parties.

Limitations on creating charges on the assets of Bezeq Group

The Communications Law, the Communications Order (which applies to the Company) and some of the communications licenses of Bezeq Group, contain limitations on the grant of rights to a third party in assets used to provide the essential service or in the assets of the license, including the need to obtain regulatory approval to create charges on these assets. In some instances, such as Pelephone's cellular operator's license and Bezeq International's ITS license, there are exceptions permitting the creation of charges in favor of banks without the need to obtain the regulator's approval in advance, provided that the charge agreement includes provisions to ensure that the enabled services will not be affected if the bank exercises the charge. In addition, under the provisions of the law and the communications licenses, the license and the resulting rights are not transferrable and they cannot be pledged or confiscated (with certain exceptions).

Bezeq and Pelephone have provided undertakings to certain financing entities that they will not pledge their assets without simultaneously creating a charge of the same class, rank and amount (negative charge) in favor of those financing entities. DBS created current charges on all its assets and fixed charges on certain of its assets, which include, among other things, restrictions on the creation of additional charges without obtaining the agreement of the financing entities.

Competition in the Israeli Communications Market

The Israeli communications market is dominated by four main groups, the Bezeq Group, the IDB group (which controls Cellcom and 013 NetVision), the Partner group, which recently purchased 012 Smile Communications Ltd. or 012 Smile and the HOT group, each having interests in one or more of the main communications sub-sectors.

IDB Group - The IDB Group provides communications services through Cellcom, a publicly held company, and its wholly owned subsidiary, Netvision Ltd., or Netvision (on August 31, 2011 a merger between Cellcom and Netvision was completed in which Cellcom purchased all the shares of Netvision). These companies provide provides cellular telephony services (including cellular Internet), fixed-line telephony mainly to business customers through its own infrastructure, transmission and data communication services for business customers through Cellcom's own transmission network, ISP services, international call services and fixed-line telephony services using Voice over Broadband, or VoB, technology.

Partner Group - The Partner Group provides communications services through Partner, a public company, which provides cellular telephony services (including cellular Internet), fixed-line telephony, transmission and data communications, ISP services, international call services and fixed-line telephony using VoB technology. In March 2011, Partner completed the purchase of the shares of 012 Smile, an international telephony services provider and ISP, from the purchaser of B Communications legacy communications business in January 2010. Partner and 012 Smile were subject to structural separation limitations between 012 Smile's international telephony operations and Partner's cellular services. According to the Partner's announcement, such restriction were removed in December 2011

HOT-Mirs Group - The HOT-Mirs Group provides communications services through HOT and through Mirs which are commonly owned. The Hot-Mirs Group owns a cable infrastructure that is deployed nationwide, and it provides multi-channel television services though HOT, as well as fixed-line telephony services. The HOT-Mirs Group also has a nationwide Internet infrastructure and provides transmission and data communications services through HOT Telecom, a subsidiary of HOT. Mirs provides cellular communication services using iDEN technology. The Hot-Mirs Group is subject to limitations separating the structure of Mirs from that of HOT Telecom and HOT Broadcasting, including full segregation of management, as well as the separation of assets and employees. Mirs was prohibited from transferring commercial information to HOT Telecom and HOT Broadcasting, or from receiving such information. However, Mirs was permitted to offer and market HOT Telecom or HOT Broadcasting services that are not part of the joint bundles and to transfer relevant information for this purpose.

In December 2010, HOT-Net, a subsidiary of HOT, was granted an ISP license, subject to similar structural separation limitations between HOT-Net, HOT and HOT Telecom and limitations on marketing joint service packages that include HOT-Net's Internet access. Among the limitations are an obligation to market service packages that correspond to competing ISPs, and an obligation to sell ISP services separately and on the same terms as they are sold when part of the service package (unbundling). In February 2012, HOT-Net launched operations.

On May 4, 2011, HOT announced that its board of directors had received a proposal from entities controlled by its controlling shareholder to join them in negotiations for the acquisition of Mirs and it had authorized a committee to take the actions necessary to review the proposal and conduct negotiations.

In June 2011, a tender was issued for the grant of frequencies and a license to cellular operators that own infrastructure. The tender was won by Mirs, which is one of the four existing operators, and Golan. During 2010 and 2011, several licenses were issued to MVNOs (virtual operators). To date, Rami Levi Cellular Communications Ltd. is the only MVNO to have commenced operations.

The Ministry of Communications has encouraged competition in the communications market by imposing restrictions and limitations on Bezeq and its subsidiaries, including:

- an obligation to maintain complete structural separation among Bezeq and its subsidiaries pertaining to corporate structure and management systems, including finance, marketing, manpower, assets and data;
- supervision and regulation of part of Bezeq’s tariffs; and
- an obligation to provide “access” infrastructure services to other licensees on an equal, non-discriminatory basis and a prohibition on granting Bezeq’s subsidiaries advantageous terms when providing such services.

The Ministry of Communications has also supported competition by:

- separating infrastructure and service providers;

- granting new licenses and encouraging new and innovative technologies; and
- mandating number portability.

In addition to HOT's cable and optical fiber network and the optical fiber infrastructures of Cellcom and Partner, there are a number of utility and transportation infrastructures in Israel that have the potential to serve as communications infrastructures, based on optical fibers networks, which are mostly owned by government companies and entities. Among these are IEC, Israel Railways, Mekorot (water grid), pipeline infrastructures companies and the Cross Israel Highway Company. Some municipalities are also trying to create an alternative to cable network services of communications license-holders by deploying their own infrastructures.

In 2010 the IEC started a technological pilot to ascertain its ability to provide a high-speed optical fiber communications infrastructure to customer homes, or FTTH. In July 2010, pursuant to a decision of the government, the Minister of National Infrastructures and the Minister of Finance exercised their authority under the Electricity Law, 1996, and granted IEC the right to operate in the communication sector subject to certain conditions. Such conditions include: the establishment of a communications company that will use a fixed-line communications infrastructure based on the electricity grid; IEC would not hold more than 49% of the means of control in the communications company and would not control it; the communications company would do business with communications license-holders and not directly with private consumers (which would exclude large business customers, for which it could provide transmission or other services, subject to the approval of the Ministry of Communications).

On March 7, 2011, the Israeli government resolved to grant IEC the right to establish a communications company together with another company, which would exclusively use and operate the fixed-line communications infrastructure of IEC’s electricity grid. On October 9, 2011, the Ministries of Finance, Communications and National Infrastructures announced that they were initiating a move to choose an investor for a communications venture that will control the establishment of a third communications infrastructure in Israel, and in which IEC would hold 49% of the share capital. A selection committee will conduct the public process. Registration to participate in the process commenced on October 10, 2011, and it is expected to last six months. On October 25, 2011, an amendment to the Communications (Bezeq and Broadcasts) (Processes and Conditions for Obtaining a General License to Render Domestic Fixed Bezeq Services) Regulations, 2011, was published, which established the conditions and regulatory requirements for granting a Carrier License to a new communications company.

In Bezeq's estimation, such a communications company, if established, would compete with Bezeq in providing infrastructure and could adversely affect its operations and results of operations, especially if that new company is permitted to provide services to operators and business customers without an obligation for universal deployment of an FTTH network or before completing deployment of a significant portion of the network.

During 2011, a tender was issued to grant frequencies and licenses for cellular operators that own infrastructure. The tender was awarded to Mirs (part of the HOT-Mirs Group) and Golan Telecom Ltd., or Golan. Under the tender conditions, the winners will be able to launch their activity after they have deployed a cellular network that initially covers 10% of the population of the State of Israel. Following this deployment, the new operators will be able to utilize the existing operator networks for a period of up to 7 years (with a possible extension based on approval for three more years), and based on the national roaming model. According to the tender, Mirs will pay NIS 710 million and Golan will pay NIS 360 million in license fees at the end of 5 years. Such license fees will be reduced by one seventh (about 14.3%) for every 1% market share accumulated in the private sector over a five-year period from the date of granting the license, so that if a new operator manages to gain 7% of the private market, it will not pay any license fees.

BEZEQ - THE ISRAEL TELECOMMUNICATIONS CORP. LTD.

Bezeq is the principal provider of communications services in Israel, providing a broad range of telecommunications operations and services, including domestic fixed-line, cellular and international communication services, multi-channel television, satellite broadcasts, Internet services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, television and radio broadcasts, and supply and maintenance of equipment on customer premises, which is referred to as network end point, or NEP services. Bezeq was founded as a government company in 1980 and became a public company in 1990 with its shares traded on the TASE.

The following chart describes Bezeq's ownership interests in its principal subsidiaries and affiliates, as at March 30, 2012:

Bezeq - The Israel Telecommunications Corp. Ltd.
Pelephone
Communications
Ltd.
Bezeq
International
Ltd.
100%
100%
Bezeq
Online Ltd.
100%
Bezeq Zahav
(Holdings) Ltd.
100%
D.B.S Satellite
Services
(1998) Ltd.
Walla!
Communications
Ltd
100%
49.78%

The Group has four principal areas of operation, which are reported as business segments in Bezeq's consolidated financial statements.

- Bezeq domestic fixed-line communications - Primarily includes Bezeq's operation as a domestic operator, including telephony services, Internet services, transmission services and data communications.

- Pelephone Communications Ltd. - Provides cellular services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems.

- Bezeq International Ltd. - Provides international communications services, Internet access (ISP) services, and NEP services.

- D.B.S. Satellite Services (1998) Ltd. - Provides multi-channel broadcast and value added services via satellite.

- Walla! Communications Ltd. - a popular Israeli provider of Internet and portal services and other investments.

Bezeq ceased to consolidate the operations of DBS into its consolidated financial statements in August 2009, but reports its operations as a segment in its consolidated financial statements. Bezeq holds 49.78% of the shares of DBS as well as options to purchase additional shares, with the balance held by Eurocom DBS, which is indirectly controlled by Mr. Shaul Elovitch. Accordingly, cooperative ventures between it and the Bezeq Group companies (such as agreements for mutual marketing of products and services) must currently be approved as transactions in which the controlling shareholder in Bezeq has a personal interest, which process could impede the business flexibility of the Bezeq Group in such cooperative ventures. In view of the position taken by the Israeli Antitrust Commissioner and the ruling of the Supreme Court in 2009, Bezeq is not permitted to increase its holdings in DBS or control it, which limits the Bezeq Group's ability to benefit fully from the advantages that could have been achieved from the inclusion of DBS in the Bezeq Group. DBS believes that if these regulatory limitations and structural separation and the other limitations applicable to cooperative ventures between the companies in the Group remain in effect, they will have a detrimental effect on DBS's financial results.

Bezeq also includes a category of “Other” in its consolidated financial statements, which mainly include customer call center services through its Bezeq Online Ltd. subsidiary, investments in a venture capital fund, a 71.55% investment in Walla! Communications Ltd., or Walla!, a popular Israeli provider of Internet and portal services and other investments. On March 14, 2012, Bezeq published a tender offer for the purchase of all the shares held by the public in Walla! at a price of NIS 5.25 per share for total consideration of NIS 68 million (if all the outstanding stock options held by Walla! employees are exercised, the total consideration would increase to NIS 77 million). The tender offer, which was contingent upon its acceptance by the majority necessary to enable the purchase of all the Walla! shares held by the public and turning the company into a private company, was successful.

The Bezeq Group holds over 195 trademarks including its principal trademarks: Bezeq, B – Bezeq's logo and Pelephone.

For detailed information about Bezeq's business, see Bezeq's Periodic Report for 2011, prepared in accordance with Israeli Securities Regulation (Periodic and Immediate Reports), 5730-1970, which report is available on Bezeq's website at http://ir.bezeq.co.il. The information on Bezeq's website is not incorporated by reference into this annual report.

BEZEQ FIXED-LINE BUSINESS

General

Bezeq has a general license for the provision of domestic fixed-line communication services in Israel. As a domestic carrier, Bezeq provides fixed-line telephony services, Internet infrastructure and access services, transmission and data communication services.

The following table provides summary condensed information concerning Bezeq's fixed - line communications segment for the three years ended December 31, 2011.

	2009	2010	2011
Revenues (NIS millions)	5,303	5,263	4,648
Operating profit (NIS millions)	1,523	2,043	1,695
Depreciation and amortization (NIS millions)	794	690	688
Operating profit before depreciation and amortization (NIS millions)	2,317	2,733	2,383
Net profit (NIS millions)	1,107	1,426	1,102
Cash flow from operating activities (NIS millions)	2,220	2,140	2,106
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	853	1,032	1,165
Proceeds from the sale of property, plant and equipment and intangible assets (NIS millions)	86	132	228
Free cash flow (in NIS millions) (1)	1,453	1,240	1,169
Number of active subscriber lines at the end of the period (2) (in thousands)	2,489	2,366	2,367
Average monthly revenue per line (NIS) (3)	82	81	76
Number of outgoing minutes (in millions)	12,196	10,883	9,757
Number of incoming minutes (in millions)	6,718	6,547	6,240
Number of Internet subscribers at the end of the period(2) (in thousands)	1,035	1,066	1,111
Percentage of subscribers using NGN services out of total Internet subscribers	12 %	34 %	48 %
Average monthly revenue per Internet subscriber (NIS)	69	75	80
Average bandwidth per Internet subscriber (Mbps)	2.7	4.3	6.7
Churn rate (4)	12.0 %	12.6 %	11.0 %

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

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

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

(4) Number of telephony subscribers who left Bezeq Landline during the period, divided by the average number of registered subscribers in the period.

Number of active subscriber lines, average monthly revenue per line, and number of outgoing usage minutes were corrected retrospectively and are presented after eliminating the effect of public call boxes operated with cards. Additionally, the number of active subscriber lines and average monthly revenue per line (ARPL) were corrected retrospectively and include IP Centrex lines.

Products and Services

Telephony

Bezeq's telephony services include basic telephony services on domestic telephone lines and associated services such as voice mail, caller ID, call waiting, call forwarding, speed dial, and conference calls. Bezeq also provides national services for businesses (1-800, 1-700) that offer full or partial payment for incoming calls by businesses. Bezeq currently operates approximately 12,500 public telephones around the country. As part of its marketing strategy, Bezeq is working on the development and launch of new services in both the private and business sectors. Bezeq plans to continue to launch additional products on the basis of market trends and customer needs.

Bezeq operates a unified telephone directory for fixed-line and cellular telephony operators (144 directory information), as well as a unified website which is free of charge. The unified directory service provides data with respect to all of the telephone subscribers in Israel. Fixed line and cellular telephony operators in Israel are required to provide unified directory services.

At the end of 2009, the Ministry of Communications published a request for positions of the public with respect to the need for and format of opening directory information services to competition, by having these services provided by entities other than telephony operators or by canceling Bezeq 144 service. Bezeq opposed the proposed alternatives. At the date of this annual report, the position of the Ministry of Communications on the matter has not yet been published. The Knesset Economic Affairs Committee discussed a bill which would obligate Carrier License and cellular license holders to provide information of its subscribers upon request on a public telecommunications directory (including a telephone or computerized database).

In its answer to a petition for an order to open Bezeq’s 144 directory information services to competition filed with the Israeli Supreme Court in July 2011, the government took the position that the petition should be dismissed for failure to state a cause of action and that the relevant issues for the claims are under review by the Ministry of Communications as part of the legislative measures awaiting completion. The government further announced that as part of the proposed bill, the Ministry of Communications is considering prohibiting the supply of information services without a license from the ministry, obligating operators to transfer their databases to such a licensee for reasonable payment, cancelling the allocation of the number 144 to Bezeq and allocating a different national access code for information services to each licensee.

Bezeq's telephony services are its principal business, and in recent years the use of and revenues from these services have declined, mainly due to competition from other telephony fixed-line service providers and cellular companies. As of December 31, 2011, Bezeq had 2,367,000 active fixed telephone lines compared with 2,366,000 active lines as of December 31, 2010.

Internet Access Infrastructure Services

The Internet market has been one of the fastest growing communication markets in recent years (although the growth in the number of subscribers has been at a slower rate than in the growth of demand for greater bandwidth) and this service has become a central focus for Bezeq’s investments in technology, marketing, advertising and customer acquisition and upgrades. In September 2009, Bezeq launched a gradual roll-out of a next generation network, or NGN, based on a core IP network and deployment of an optical fiber network to street cabinets, known as fiber to the curb, or FTTC.

As of December 31, 2011, Bezeq had 1,111,000 Internet subscribers compared with 1,066,000 as of December 31, 2010. At December 31, 2011, the percentage of Internet subscribers connected to the NGN was approximately 87%

of Bezeq's total Internet subscribers, and the percentage of subscribers using NGN services (those with packages of 10 mbps or higher) was 48% of all Internet subscribers connected to the NGN network (approximately 42% of all Bezeq's Internet subscribers).

In 2011, an increase of approximately 4% was recorded in the number of Bezeq's Internet subscribers, and an increase of approximately 7% in the average monthly revenue per Internet subscriber, compared with 2010. The increase in revenues is attributable to the increase in the speeds offered in Bezeq surfing packages and the adoption of advanced services and value added applications.

Data Transmission and Communication Services

Data communications services are network services for point-to-point transfer of data, transfer of data between computers and various communications networks, services to connect communications networks to the Internet, and remote access services.

Data communication services are provided over established traditional infrastructures such as Sifranet and Frame Relay, on ATM infrastructure and on innovative and advanced infrastructures such as Internet Protocol, or IP, based virtual private networks, or IPVPN and Metro Ethernet. The IPVPN infrastructure enables managed communications solutions for businesses by connecting the various branches of the organization. Metro Ethernet infrastructure enables the supply of a communications infrastructure in Ethernet technology for services in the business and private sector. In recent years, customers have begun to switch from data communication solutions provided over older and traditional infrastructures, to IP and Ethernet-based infrastructures. This permits Bezeq to offer its customers greater capacity at lower prices, and the demand is increasing.

Bezeq offers transmission services, including high speed services, to other communications operators and to its business customers over a variety of protocols.

Other services

Services to communications operators. Bezeq provides services to other communications operators, including the cellular and international operators, HOT, NEP operators, ISPs, domestic operators, and Palestinian communications providers. Bezeq’s services include infrastructure, infrastructure upgrade, connection to Bezeq's network, transmission, billing and collection, rental of space and provision of services in its rented properties and rights of use for submarine cables.

Broadcasting services. Bezeq operates and maintains radio transmitters which are operated by radio stations and operators including, the Israel Broadcasting Corporation and the Israeli Defense Force Radio (Galei Zahal). Bezeq also operates digital terrestrial television, or DTT, transmitters for the Second Authority for Television and Radio. Bezeq is responsible only for operating and maintaining the transmitters, but not for the content of the broadcasts.

Contract work. Bezeq performs setup and operation work on networks and sub-networks for various customers such as the Ministry of Defense, HOT, radio and television broadcasting companies, cellular and international communication operators, local authorities, municipalities and government agencies. Bezeq and HOT have agreements for the provision of installation and maintenance services of cable networks, on Bezeq's infrastructure, from the starting point of those licensees’ operating center, up to the point of delivery at the entrance to subscribers’ homes. The connection and maintenance from these points to the subscribers’ homes is not Bezeq’s responsibility.

IP Centrex. The IP Centrex service is a virtual private exchange service.

Data Centers. Data Center service enables provision of a solution for customers from the aspects of backup and survivability.

144 Internet site (B144). A search engine for finding business and private telephone numbers.

The table below shows data for the distribution of Bezeq's revenues by principal product and service in its segment of operation, 2009-2011:

	2009	2010	2011
		(in NIS millions)	
Revenues from line telephony	3,333	3,160	2,393
Percentage out of total Company revenues	62.85 %	60.04 %	51.49 %
Revenues from Internet infrastructure services	863	977	1,092
Percentage out of total Company revenues	16.27 %	18.56 %	23.49 %
Revenues from transmission and data communication services	851	882	931
Percentage out of total Company revenues	16.04 %	16.76 %	20.03 %
Revenues from other services	256	244	232
Percentage out of total Company revenues	4.84 %	4.64 %	4.99 %
Total revenues from domestic fixed-line communications services segment	5,303	5,263	4,648

Customers

Bezeq’s sales are divided into two main sectors: the private sector which accounts for approximately 60% of revenues and the business sector which accounts for approximately 40% of revenues. Bezeq is not dependent on any single customer or small number of customers, the loss of which would materially affect its operation, and there is no customer, which accounts for 10% or more of Bezeq's total revenue.

The following table provides Bezeq’s revenues for these two sectors during the three years ended December 31, 2011:

	2009	2010	2011
		(in NIS millions)	
Revenues from private customers	3,165	3,128	2,777
Revenues from business customers	2,138	2,134	1,871
Total revenues	5,303	5,263	4,648

Competition

Domestic fixed - line telephony services

Since 2005, the Ministry of Communications has granted several general licenses for the provision of fixed-line domestic services without a geographical deployment or universal service obligations. In 2011, the number of Bezeq fixed-line customers was relatively stable, however, this market has been characterized by a decline in demand and in prices, with an annual decrease of approximately 5% in number of customers over the past five years). In 2011, a decrease of 7% was recorded in the volume of average call minutes (incoming and outgoing) on Bezeq's fixed telephone lines compared with 2010. This is a continuation of the trend of decreasing volume in fixed-line calls recorded in recent years, which Bezeq believes is attributable to the increase in calls from cellular telephones usage and calls over the Internet, and from competition from other Carrier License holders. The average monthly revenues from a telephone line fell by 6% in 2011.

Bezeq believes that as of December 31, 2011, its market share in the fixed-line telephony market was approximately 63% in the private sector and 76% in the business sector, compared with 65% and 78% as of December 31, 2010, respectively. There is a high degree of competition in the fixed-line communications segment in Israel.

Bezeq and HOT Telecom both own nationally-deployed fixed-line telephony infrastructure. HOT markets service packages combining Internet infrastructure, Internet access, telephony and cable television and cellular services aimed mainly at households. In addition, HOT markets telephony services to business customers. Bezeq faces competition from five license-holders for domestic fixed-line communications services, including VoB.

The penetration rate of cellular telephony in Israel is among the highest in the world at 129%. Bezeq believes that this penetration rate, combined with relatively low airtime rates and large prepaid bundles of minutes, have made the cellular telephone a product that largely substitutes for the landline telephone. Bezeq believes that the increased substitution of cellular phones for fixed line telephones is one of the causes of the growing loss of installed telephone lines.

Partner and Cellcom also provide fixed-domestic fixed-line services through corporations they own, and they sell service packages that combine fixed-line and cellular telephony and Internet services

In December 2010, the Ministry of Communications published a hearing in the matter of setting a policy for VoC services (a virtual cellular operator of telephony based on broadband), for review of the regulation of these services under an MVNO license and/or as part of a special VoB Carrier License. In response to the hearing, Bezeq stated that it wished to provide VoC services as such services are the continuation of VoB services. Bezeq believes that marketing VoC services under a VoB license, if allowed, will enable telephony services to be provided at fixed-line call prices on the cellular network and may increase competition in the telephony market.

On December 20, 2011, the Ministry of Communications announced that it is considering changing the tariff structure for high-speed access through Internet suppliers and causing Bezeq to (i) set the price for its asymmetric digital subscriber line, or ADSL, service so as to include its relative share of the cost of the access; (ii) no longer supply NDSL services to existing and new customers; and (iii) set standard tariffs for ADSL services. On January 12, 2012, Bezeq submitted its comments to the hearing and stated that the format proposed by the Ministry is inconsistent with the law, with the interests of the consumers and with proper administrative procedure and it is unreasonable and cannot be implemented. On March 5, 2012, the Ministry resolved to abolish the ADSL-only service enabling subscribers without telephony to receive ADSL service for no additional payment. Accordingly, as of April 5, 2012, Bezeq cannot apply differing ADSL pricing for subscribers who use the service together with telephony service and subscribers who only use the ADSL service. It is expected that the abolishment of the ADSL-only service will adversely impact Bezeq.

Internet Infrastructure Market

Bezeq believes that as of December 31, 2011, its market share in the Internet infrastructure market was approximately 59%, similar to its market share at the end of 2010. There is significant competition in this field from the HOT Group and from the cellular operators. The Ministry of Communications' policy requires Bezeq and HOT to provide ISPs with "open access" to their infrastructure.

HOT's Internet infrastructure is deployed nationwide and was recently upgraded to an Ultra Fast Internet, or UFI, network in which a range of communications services and interactive applications can be provided. The network is currently the principal competitor with Bezeq in the private sector. In December 2010, HOT-Net was granted an ISP license, subject to structural separation limitations between HOT-Net, HOT and HOT Telecom, and limitations on marketing joint service packages that include HOT-Net's Internet access. Among the limitations are an obligation to market service packages that correspond to competing ISPs and an obligation to sell the ISP services separately and on the same terms as they are sold when part of the package. The grant of the ISP license to HOT-Net is expected to increase the level of competition in Internet access. The upgrade of the infrastructure and grant of an ISP license to HOT-Net in December 2010 are expected to increase the level of competition in Internet access and could also increase the number of HOT customers who subscribe to service packages.

The cellular companies have deepened their Internet activities on the cellular networks both in the private sector and in the business sector. Unlike the fixed-line communications segment (where the provision of access infrastructure services by HOT is separate from the provision of Internet access services by the ISP), cellular Internet service is provided as one unit. Surfing services are provided both from the cellular handset and through a cellular modem that connects laptop and desktop computers in combination with Internet access services.

Transmission and Data Communication Services

The companies operating in this field are Cellcom, Partner (which acquired the Med-1 operations), HOT, and Internet companies that also use leased infrastructures. To the best of Bezeq's knowledge, Cellcom has deployed and set up a transmission network, which it uses both for its own needs (instead of transmission provided for it in the past by Bezeq) and for competition with Bezeq in the transmission and data communications market. Cellcom offers its customers a complete package of solutions that includes domestic telephony, data communication and cellular communication, using its own infrastructure and its own sales array. Partner has also stepped up its activities in providing transmission and data communication services combined with telephony, for business customers.

Under the terms of its license, Bezeq is obliged to provide some of its communications services to the entire public in Israel. According to the Ministry of Communications interpretation of this and other provisions in the Carrier License regarding the provision of infrastructure services to license-holders, Bezeq is also obliged to provide infrastructure and transmission services to competing communications operators for providing services which compete with those of Bezeq. In October 2010, the Ministry of Communications notified Bezeq that it had violated the provisions of its license by refusing to provide transmission services to the domestic operator companies controlled by Cellcom and Partner, and that if Bezeq did not give notice within seven working days that it had ceased the violation, the Ministry would be compelled to institute a proceeding for the imposition of a financial sanction or to consider some other action. Bezeq acted in accordance with the Ministry's decision but demanded the basis and reasons for it.

Marketing

Bezeq has marketing, sales and service groups for both the private and business sectors, which include customer managers for the business sector, combined sales and service centers located throughout Israel, technical support centers for private and business customers and 16 points of sale and service (the Bezeq Store network) in Israel, as well as a virtual online shop.

Bezeq markets its fixed-line services mainly through mass media advertising and telesales centers, customer managers, and a system of independent dealers including ISPs, and outsourced points of sale.

Networks and Equipment

Bezeq’s property and equipment consist primarily of domestic telecommunications infrastructure, exchanges, various networks, real estate (land and buildings), computer systems, vehicles and office equipment. The telecommunications infrastructure has five principal components deployed throughout Israel:

- Exchanges - Used for switching calls and transferring them from their origin to their destination based on the signal received from the subscriber.

- Transmission network - A system through which there is connectivity between exchanges. This system actually functions as a national backbone that connects the local networks, each consisting of an exchange and an access network to it. The transmission network is based primarily on fiber-optic systems and to a lesser degree on wireless systems.

- Data communications networks - Networks for the provision of data communication services at various speeds and communication protocols.

- Access network - A system that connects subscriber NEPs to the exchange. The network is based on copper pairs, fiber-optic cables and to a lesser degree on wireless systems.

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

Next Generation Network

The demand for communications services in Israel and worldwide is characterized by a demand for ever-increasing bandwidths and advanced IP platforms. In order to meet this demand, in September 2009 Bezeq launched a gradual roll-out of its NGN based on a core IP network and deployment of FTTC. Using VDSL2 technology, bandwidth of up to 100 mbs download speed can be provided by this network, as well as innovative value added services. Other advantages of the new technology are a simplification of the network structure and better management ability. As of December 31, 2011, Bezeq had completed deployment of the network to approximately 85% of households in Israel. Bezeq expects that by the end of 2012 its NGN will be available to almost all households.

Bezeq is extending its infrastructure, including its distribution of fiber optic cable so as to further increase bandwidth for its customers. To this end, Bezeq is examining a series of technologies, based both on the existing network and on the deployment of an optical fiber network to the customer's home (FTTH/FTTB). This review requires Bezeq to prepare itself and deploy its systems, and Bezeq has begun working in this direction. In this context, Bezeq is currently conducting a trial in which the homes of a limited number of customers will have bandwidth access of up to 1 GB.

Computing

Bezeq’s IT system supports four central areas: (i) marketing and customer management; (ii) information systems for engineering infrastructures of the telecommunications networks; (iii) information systems for management of Bezeq fixed-line resources; and (iv) company - wide systems.

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

Information systems for the engineering infrastructures of the telecommunications networks. These systems support the planning, management, control and maintenance of engineering resources for the provision and assurance of the services.

Information systems for management of the Company's resources. These systems support the management, control and maintenance of the expense side of Bezeq’s activities, including, financial information (including budget and control), purchasing and stock processes, property, real estate, human resources, salary control, fleet management, company projects, etc.

Company-wide systems. Bezeq maintains large and complex computer information systems that support critical work processes and handle very large volumes of data. The array of information systems consist of a large number of systems, some of which are legacy systems which were developed many years ago and operate on mainframe computers, and more modern systems, whose applications were developed more recently and operate in open computerization environments. The systems support decision-making processes utilizing a data warehouse operated by Bezeq. Bezeq also operates a website which provides information about its services and enables the display of information about telephone bills, payment information and other services. Bezeq also maintains computerized office systems (e-mail, decision follow-up, etc.), and knowledge management systems.

Bezeq also develops and utilizes advanced computerization systems for its operations, including a customer relations management, or CRM, system, engineering network management systems and service order and supply systems.

Royalty Payments

Bezeq's royalties expense in 2011 was approximately NIS 56 million, compared with NIS 31 million in 2010. The royalties rate for 2011 was 1.75% of taxable income (as defined in the regulations), compared with 1% in 2010.

The Communications Law states that a holder of a license for providing telecommunications services shall pay royalties to the government out of its revenues from providing the services named in the regulations. Bezeq is subject to such royalties that are imposed on Carrier Licensee holders, on international call service license holders and on cellular license holders. In 2010, the royalties were lowered to 1% per year, however, on January 19, 2011, a temporary order was published stating that the royalties to be paid by a Carrier Licensee (excluding a special domestic carrier) and a cellular licensee would increase to 1.75% in 2011 and to 2.5% in 2012. The temporary order will remain in effect until the earlier of (i) December 31, 2012; (ii) for a Carrier License that received its license in 2011 or thereafter, the day the licensee deploys its infrastructure to 5% of the population; or (iii) for a cellular licensee, the day it started providing domestic roaming services or the MVNO wholesale market share is less than 5%.

In addition, the Royalties (Satellite Broadcasts) Regulations impose a duty on a satellite broadcasts licensee (DBS) to pay royalties at the rate of 1% of its taxable income. In August 2011, the Knesset approved an amendment to the applicable regulations so that in 2011 and 2012 the rate of royalties would be 1.75% of taxable income and would revert to 1% commencing in 2013 or upon meeting certain terms provided in the regulations, which relate to competition in the domestic and cellular markets in Israel.

On February 28, 2011 Bezeq, as well as other telecom companies, including Pelephone, filed petitions against this temporary order with the Israeli Supreme Court. On July 31, 2011, the government agreed to the Supreme Court's proposal that the rate of royalties in 2012 be reduced to 1.75%, and from 2013 and thereafter they will be 0%. On September 20, 2011, the government notified the Supreme Court that the wording of the amended Satellite Regulations included part of its proposal with respect to 2011 and 2012 only and the arrangement for 2013 will be included in a subsequent amendment. On January 31, 2012, the Knesset Economic Committee approved an identical amendment to the regulations relating to licensed cable broadcasters. To the best of Bezeq's knowledge, publication of the amendment has been postponed until a parallel amendment is approved for DBS.

Although DBS is not one of the petitioners, according to its announcement, the government also applied the settlement to DBS, and an amendment to the relevant regulations, together with the regulations relating to Bezeq and Pelephone, was submitted to the Knesset Finance Committee for approval, setting the rate of royalties for 2013 at 0%. This amendment has yet to be approved.

Bezeq's Carrier License

The principal provisions of Bezeq’s Carrier License include:

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

- Principles of structural separation - Bezeq must operate under the principles of structural separation. In order to comply with this requirement, Bezeq employs various compliance procedures and provides its employees with training sessions and periodic refresher courses on the relevant procedures. In 2009, the Ministry of Communications notified Bezeq that it was considering imposing a NIS 15 million monetary sanction on Bezeq because of an alleged violation of the provisions of the license relating to structural separation. Bezeq submitted a detailed response to the notice, stating that it had not violated the provisions of the license and the imposition of a monetary sanction was unjustified. As of the date of this annual report, the ministry has not submitted an answer to Bezeq’s response.

- Marketing joint service bundles - Bezeq may request permission to market joint service bundles, subject to certain limitations.

- Tariffs – If Bezeq provides a service or package of services for which no tariff is set under the Communications Law, it must be offered at a reasonable price to all, without discrimination and at a uniform tariff.

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

- Interconnect and use - Bezeq is required to provide interconnect services to other public switching networks and to provide the option of use of such services by other license holders; Bezeq has a duty to provide infrastructure services to other license holders on reasonable and equal terms and must refrain from providing preferable terms to its affiliates.

- Security arrangements - Provisions have been made for the operation of Bezeq's network in times of emergency. Bezeq is required to design and operate its network in a manner that will prevent its collapse in an emergency. Bezeq provides special services to the defense forces and is required to provide telecommunications services and maintain terminal equipment infrastructure for the security forces in Israel and abroad, as provided in its agreements with the defense forces. Bezeq is required to appoint a security officer and to comply fully with the security instructions contained with the applicable provisions in its license.

- Supervision and reporting – The license imposes on Bezeq extensive reporting requirements to the Ministry of Communications. In addition, the Director General of the Ministry of Communications has the authority to enter the facilities and offices used by Bezeq and to seize documents.

- Miscellaneous –

  - The Carrier License includes limitations on the acquisition, maintenance and transfer of means of control pursuant to the Communications Order, as well as on cross-ownership, which are mainly a ban on cross-holdings by entities with an interest in another material domestic carrier, and limitations on cross-holdings by entities with Carrier Licenses or general licenses in the same segment of operation.

  - Bezeq is required to prepare a draft of any agreements it plans to offer to subscribers, and to submit them to the review of the Director General upon demand. The Director General has the authority to instruct that changes be made. Bezeq is in the process of preparing such an agreement.

  - Pursuant to the requirement of the license, Bezeq submitted to the Director General a $10 million bank guarantee to secure its fulfillment of the terms of the license and to indemnify the State of Israel against any loss it may incur due to violations. The Minister may declare the guarantee or part of it forfeit on terms set out in the license.

  - The Director General has the power to impose a monetary sanction for violation of any of the terms of the license.

  - During a calendar year, Bezeq may invest up to 25% of its annual income in activities not connected with the provision of its services (the income of its subsidiaries is not considered income for this purpose). The Minister of Communications is authorized to grant a variance from that percentage.

Tariffs

Bezeq's telephony tariffs are prescribed in regulations promulgated by the Minister of Communications with the consent of the Minister of Finance. As a result of a deliberate regulatory policy, the monthly usage tariff for a telephone line is set at a level that does not cover the costs involved in providing it (a situation known as "accessibility deficit"). This deficit has been reduced over the years, but still exists.

Pursuant to the Communications Announcement (Bezeq and broadcasts) (Calculation for Bezeq payments and linkage thereof), 2011, Bezeq's tariffs were revised commencing June 1, 2011, based on the revision formula prescribed in the Communications Regulations (Bezeq and Broadcasts) (Calculation and linkage of payments for Bezeq services) (Amendment), 2007, so that the fixed monthly payment for a telephone line and for a basic service integrated digital network rose by 2.66% and the other services provided by Bezeq that are prescribed in the regulations (including the interconnect fees regulations) were reduced by 0.65%.

Suppliers

During 2011, Bezeq had no suppliers that accounted for more than 5% of the Bezeq Group's total annual purchases, nor did it have any suppliers who accounted for more than 10% of total purchases in a specific segment of operation.

Most of the equipment purchased by Bezeq for data communication, switching, transmission and radio systems have been specially modified or developed for its use and the ability to obtain support other than through the manufacturer is limited.

Bezeq believes that, in view of the importance of manufacturer support for certain of its systems used, it may become dependent on: (i) the Alcatel Group, represented in Israel by Alcatel Telecom Israel Ltd., for transmission network equipment for public switching and metro transmission; (ii) Dialogic Networks (Israel) Ltd. for migration exchanges for linking operators to Bezeq's switching network; (iii) Comverse Inc. for switching exchanges for end customers on the NGN network; (iv) Nokia-Siemens Networks Israel Ltd. (Bezeq was recently informed that Adtran Inc., an American manufacturer, intends to acquire the access system operation) for access systems for the NGN; (v) Oracle Corporation for database and Customer Relations Management (CRM) systems; (vi) Anubex NV for open work environments that allow systems that have been converted from MF systems to work in an open environment; (vii) EMC Corporation for hardware solutions for back-up, recovery and archiving of systems and infrastructures; (viii) VMware, Inc. for the virtualization of its servers; and (ix) ECI Telecom Ltd for the transmission network that connects Bezeq's network and its business customers.

Agreements with suppliers on which Bezeq may be dependent are generally long term and usually include a warranty period for a specified period, followed by another period of maintenance or support. Where necessary, Bezeq may enter into an agreement with a supplier for the supply of support and/or maintenance services for further periods. These agreements usually contain various forms of relief for Bezeq should the supplier breach the agreement.

Property

Bezeq initially obtained its real estate assets from the State of Israel in 1984 pursuant to an asset transfer agreement and has acquired additional properties since then, including properties leased from third parties. Bezeq owns or has long term ownership rights in approximately 410 properties all over Israel. The total area for which Bezeq has full ownership rights or capitalized lease rights (including joint lease rights as described below) is 1,100,000 square meters of land, of which 300,000 square meters have been improved. Six of these properties, with a total area of 7,000 square meters and including improved properties of 500 square meters, are in Israeli towns in the Administered Territories. Of the 410 properties, approximately 390 properties consisting of 1,000,000 square meters of land and improved properties of 240,000 square meters are used for communications purposes, with the remainder used for administrative purposes. Of the foregoing properties, 40 are jointly owned with the Ministry of Communications and/or the Israel Postal Authority (now Israel Postal Co. Ltd.), or the Postal Authority. On June 30, 2001, an agreement was signed between Bezeq and the Postal Authority defining and regulating the rights of Bezeq and the Postal Authority in these properties.

Bezeq has rights to an area of approximately 70,000 square meters, net, in Sakia, Israel for warehouse and office use. Bezeq is in advanced stages of negotiation with the Israeli Lands Administration, or ILA, to obtain an authorization to prepare development plans for the area.

In addition to the 410 properties referred to above, Bezeq holds approximately 60 properties in the Administered Territories, covering a total area of 9,300 square meters of land and approximately 1,500 square meters of improved space. There is no written regulation of the contractual rights for these properties, but Bezeq believes that this does not create material exposure. The real estate assets are used by Bezeq for communications activities (exchanges, neighborhood rooms, broadcasting sites, etc.) and for other activities (offices, storage areas, etc.). Some of the properties are undeveloped or partially developed and can be used for other purposes.

Bezeq also leases approximately 290 properties consisting of 63,000 square meters (approximately 280 of these properties have improved space of approximately 9,400 square meters, which are used for communications purposes, while the rest are used for administrative purposes.

Bezeq has an interest (transition rights, etc.) in other real estate, including for the erection of transmitters and for laying cables. Bezeq also has at its disposal approximately 550 neighborhood rooms (for cables and installations used for neighborhood communications) having a total area of approximately 8,310 square meters. No written agreements exist as to the rights of usage for most of these rooms.

Bezeq's rights to a considerable number of its real estate assets are not registered in the Lands Registry, and therefore its rights correspond to contractual rights. Bezeq is in the process of registering those properties which can be registered in its name in the Lands Registry.

According to a settlement agreement entered into in 2004 between Bezeq, the ILA and the State of Israel, which concerns most of the real estate that was transferred to Bezeq pursuant to the 1984 asset transfer agreement with the State of Israel, the assets remaining in Bezeq's possession have the status of a capitalized lease and are subject to the execution of individual lease contracts (to date contracts have been signed for approximately 80 of the 215 properties for which contracts are required). The settlement agreement allows Bezeq to enter into transactions and to enhance the properties beyond the rights according to plans approved in the settlement agreement and it provides for a mechanism for payment to the ILA for such enhancements, if undertaken, at the rate of 51% of the increase in value of the property following the enhancement (less part of the amounts paid for a betterment levy, if paid). The settlement agreement also provides that 17 properties must be returned to the ILA. Bezeq has returned 15 of those properties and the two remaining properties will be returned after Bezeq receives substitute properties, as provided in the settlement agreement.

Following a review by Bezeq's management, Bezeq’s Board of Directors approved further sales of properties which are not currently utilized or which can be easily vacated without incurring significant expenses. The transition to the NGN allowed Bezeq to increase the efficiency of its network and to vacate and sell some of its real estate assets. The sale of real estate assets that are not active or that can easily be vacated without incurring significant expenses may generate significant capital gains for Bezeq. At this stage Bezeq is unable to predict what consideration will be received if and when these real estate assets are sold. During 2010 and 2011, Bezeq sold 10 and 11 of such properties, respectively, for approximately NIS 150 million and NIS 136 million, respectively.

On July 13, 2011, Bezeq’s board of directors authorized the purchase of a 25,000 square meter plot in Petach Tikvah's Kiryat Aryeh industrial zone, for an estimated price of NIS 125 million plus VAT. The property is slated for the construction of offices and communications facilities to replace existing offices. If an agreement is reached, construction and occupancy are scheduled for completion four years from the date of the agreement. According to Bezeq's initial estimates, the entire project will cost NIS 700 to 800 million (including the price of the land and the relevant levies). This cost will be spread over the period of the project in line with the pace of progress of the construction activity.

Employees

The following table provides data relating to the number of persons employed by Bezeq as of December 31, 2010 and 2011:

	Number of employees	
Description of employment framework	2010	2011
Senior managers excluded from application of the Company’s collective bargaining agreements	63	63
Permanent employees employed under collective agreements (without new permanent employees)	3,073	2,847
Permanent employees employed under collective agreements (new permanent employees)	-	437
Employees employed under personal agreements that are not part of the collective agreements	684	666
Employees employed under individual agreements on the terms of the collective agreement	8	44
	2,038	1,948

Employees employed in accordance with the special collective agreement of December 2006, on an hourly basis		
Employees employed under the special collective agreement of December 2006, on a monthly basis	1,350	1,071
Total	7,216	7,076

Bezeq has 12 directors, including two external directors, two employee-directors and two "independent" directors pursuant to Section 249B of the Companies Law. In addition, senior management has 15 member representatives. Since January 1, 2011, Mr. Shaul Elovitch has served as Chairman of the Board of Directors of Bezeq.

The members of senior management are employed under personal agreements which include, pension coverage, payment of bonuses based on targets, and additional retirement benefits. Bezeq also allots options to the members of senior management at its discretion.

Labor relations are regulated by the collective agreements between Bezeq, its workers' representatives and the New General Federation of Workers, or the Histadrut, and by personal contracts. Additionally, expansion orders to certain general collective agreements apply to Bezeq employees, such as cost-of-living increment agreements.

In December 2006, a special collective agreement was signed between Bezeq, its workers' representatives and the Histadrut, regulating the labor relations in Bezeq following the transfer of control in Bezeq from the State to Ap.Sb.Ar. Holdings Ltd., and determining a new organizational structure for Bezeq. Under the agreement, all prior agreements, arrangements and traditional behavior in Bezeq, including the linkage of wages to the public sector, would continue to apply only to the veteran permanent employees. According to the agreement, any hiring of existing and future temporary workers is made on the basis of monthly/hourly wage agreements based on a wage model according to occupation, with high managerial flexibility. The agreement sets out limitations on certain kinds of future organizational changes and a mechanism of notification, negotiation and arbitration with the workers' representatives in the event such organizational changes. The agreement also states that Bezeq can, at its discretion, terminate the employment of 245 permanent employees in each of the years 2009 – 2013. Under the agreement, during the term of the agreement, two employee-directors will serve on the Board of Directors of Bezeq, who would be proposed by the workers' representatives. The employee-directors are not entitled to payment for their service as directors and do not participate in Board discussions of the terms of employment of senior employees.

On December 19, 2010, an amendment to Bezeq's collective agreement, which will be in effect until December 31, 2015 (with an option for an extension until December 31, 2017) was entered into. The main points of the amendment are:

- Extension of the retirement arrangements under the collective agreement to December 31, 2016. Under these retirement arrangements, Bezeq may, at its discretion, terminate the employment of up to 245 permanent employees in each of the years 2010 – 2016.

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

- Agreement of the workers' representatives to a distribution by Bezeq to its shareholders that is in excess of profits of up to NIS 3 billion ($845 million), subject to the approval of a court of law pursuant to Section 303 of the Israeli Companies Law and subject to an allotment of options to employees as described below and subject to confirmation from the ratings companies S&P Maalot and Midroog that the rating of Bezeq's debt after the distribution will not fall below AA and Aa2 respectively.

- Bezeq granted to its employees, subject to the approval of the general meeting of the shareholders, without any monetary consideration, options to purchase 70,000,000 ordinary shares of NIS 1 par value each (which are subject to a mechanism similar to the exercise of stock appreciation rights), accounting for approximately 2.61% of the issued capital of Bezeq before the grant of such options, at an exercise price of NIS 7.457 ($2.10), which will be adjusted for changes in the share capital and for distributions of dividends.

- A one-time performance bonus in 2010 of approximately NIS 52 million ($15 million) which was paid in two equal installments in January 2011 and January 2012.

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On January 24, 2011, Bezeq's Board of Directors approved a plan for the early retirement of up to 260 employees in 2011 (which includes completion of an early retirement plan for 2010) at a total cost not to exceed NIS 281.5 million. This plan was completed in 2011.

Employee stock options plan – 2010.

On December 19, 2010, the Board of Directors of Bezeq approved an employee stock option plan (also covering two employee-directors and excluding senior management), providing for the issuance of options to purchase 70,000,000 ordinary shares of NIS 1 par value each, accounting for approximately 2.61% of the issued capital of Bezeq (before the allotment), at an exercise price of NIS 7.457, to be adjusted for changes in the share capital and for the distribution of dividends. The options will vest in three equal annual installments. The vesting dates of each installment will be on the first, second and third anniversary of the date of grant. The options will be exercisable commencing two years from the date of grant and will terminate five years from the date of grant (and in any case, no later than the date on which the plan expires – December 31, 2018). The allotment of the options was approved at the general meeting of the shareholders held on January 11, 2011. As of March 13, 2012, options exercisable into 67,963,584 shares (net of options that expired) had been allotted. The exercise prices are subject to adjustments for dividend distributions, provided that the exercise price after the adjustment is not less than the par value of the share (NIS 1). The exercise price of the options as of March 14, 2011 is NIS 6.29.

"Phantom" stock options plan for senior employees – 2010.

On December 30, 2010, the Board of Directors of Bezeq adopted a "phantom" stock option plan under which 16,400,000 "phantom" options will be granted to senior managers of Bezeq, Pelephone and Bezeq International, and which will be exercisable for a monetary bonus (and not for Bezeq securities) in an amount equal to the difference between the average price per share during the 30 day period prior to the date of grant (subject to adjustments) and the closing price of the shares on the trading day before the date of the notice of exercise. The options will vest in three equal annual installments. The vesting dates of each portion will fall on the first, second and third anniversary of the date of grant. The options can be exercised commencing from the end of the vesting period of each installment, until the lapse of five years from the date of grant. All the options under this plan were allotted on January 1, 2011. As of March 13, 2012, 16,100,000 phantom options were outstanding.

2007 stock options plan.

On March 25, 2007, 78,151,368 options were allotted free of charge based on criteria contained in a collective agreement dated December 5, 2006 with Bezeq's employees (excluding senior management). The options, which were exercisable for 78,151,368 shares of Bezeq, or approximately 3% of Bezeq's capital, have an exercise price (subject to adjustment) of 50% of the closing price of Bezeq’s shares prior to the date of allotment (NIS 3.201 per share). The options were blocked for two years from the date of allotment and can be exercised during the three years from the end of the blocking period. As of March 24, 2012, 78,107,472 options from this plan had been exercised. On March 24, 2012, this plan came to an end and any options that were outstanding expired.

Stock options plan for senior managers in the Bezeq Group -November 2007.

This stock option plan for managers and senior employees of Bezeq and its related companies provides for the allotment of up to 65,000,000 non-marketable options. At the time the plan was approved, the 65,000,000 shares of Bezeq that were issuable, accounted for approximately 2.5% of Bezeq's issued share capital and approximately 2.37% at full dilution. The plan includes a mechanism for exercise of stock appreciation rights, so that the holder would receive a number of shares reflecting the value of the benefit only, without actually paying the exercise price. The options vest in three equal annual portions. The vesting dates of each portion fall at the end of each of the first, second and third years from the date of grant, respectively. The exercise price of each option is NIS 5.50 and reflects a discount of approximately 16.8% on the closing price of Bezeq's shares on the Tel Aviv Stock Exchange on January 31, 2008, the date of approval by the general meeting. In accordance with the resolution of Bezeq's Board of Directors on June 26, 2008, the exercise price of each option allotted from that date onwards is equal to the average closing price of Bezeq's shares for the thirty days prior to the date of the Board's decision to allot the options. At March 13, 2012, 59,016,667 shares had been offered in accordance with this stock option plan (net of options that had expired), including to the CEO of Bezeq and a former Chairman of the Board of Directors. The exercise prices according to this plan are adjusted to certain changes in the share capital and for dividend distribution, provided that the exercise price after the adjustment is not less than the par value of the share. As of March 14, 2012, the adjusted prices of the options range from NIS 1.62 to NIS 7.10 and the average adjusted exercise price (weighted) of the outstanding options under this plan is NIS 2.35.

PELEPHONE

General

Pelephone provides cellular communications services and sells and repairs terminal equipment. Pelephone's revenues include revenue from cellular communications customers (payments for call minutes, regular subscriptions, value-added services and roaming services), revenue from the sale of terminal equipment and in respect of terminal equipment services and interconnect revenues from other communications providers.

Four companies with a general license to provide cellular services currently operate in Israel. In June 2011, a tender was issued to grant frequencies and a license to cellular operators that own infrastructure. The tender was won by Mirs, which is one of the four existing operators, and Golan. During 2010 and 2011, several licenses were issued to MVNOs (virtual operators). To date, Rami Levi Cellular Communications Ltd. is the only new cellular operator to have commenced operations.

The Cellular Market

In recent years, the cellular market has been characterized by lower growth rates than in the past due to saturation of the market. The competition's focus on increasing growth rates encourages companies in the field to increase the range of services and products offered to customers, increase their segmentation and make special offers to various target groups, providing specific responses to their needs. The following table reflects the number of cellular subscribers in Israel at December 31, 2009, December 31, 2010 and at September 30, 2011:

	2009	2010	2011
Number of subscribers	9,560,000	9,902,000	9,924,000
Penetration rate (*)	127 %	127 %	125 %

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

As a result of the intensifying competition among the operators and the saturation of the market, the cellular market is also characterized by an increase in the churn rate that increases the sales and marketing costs of the operators while eroding pricing, even when the total number of subscribers does not fall.

The following table provides summary condensed financial information concerning Bezeq's Pelephone cellular segment for the three years ended December 31, 2011:

	2009	2010	2011
Revenues from services (NIS millions)	4,256	4,550	3,637
Revenues from sale of terminal equipment (NIS millions)	1,120	1,182	1,911
Total revenue (NIS millions)	5,376	5,732	5,548
Operating profit (NIS millions)	1,190	1,383	1,360
Depreciation and amortization (NIS)	603	601	561
Operating profit plus depreciation (NIS millions)	1,794	1,984	1,921
Net profit (NIS millions)	875	1,033	1,056
Cash flow from operating activities (NIS millions)	1,115	1,219	800
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	559	397	382

Free cash flow (in NIS millions) (1)	560		822		418	
Number of subscribers at the end of the period (thousands) (2) (7)	2,766		2,857		2,847	
Average number of minutes per subscriber per month (3) (7)	333		349		375	
Average monthly revenue per subscriber (NIS) (ARPU) (4) (7)	132		135		107	
Average monthly revenue per subscriber (NIS) (ARPU) (based on reduced interconnect tariffs) (5) (7)	N/A		111		107	
Revenue from added value services (included in revenues from services) (NIS millions)	782		1,014		1,201	
% revenues from value added services and content out of revenue from cellular services	19.6	%	23.8	%	35.5	%
Churn rate (6) (7)	13.8	%	15.3	%	22.9	%

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

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

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

(4) Average monthly revenue per subscriber is calculated by dividing average monthly total revenues from cellular services, repair and other services in the period, by the average number of active subscribers in the same period. The revenue was calculated based on the interconnect tariffs in force for each period.

(5) In view of the reduction in interconnect tariffs commencing January 1, 2011, average monthly revenue data per subscriber for all three years is based on the reduced interconnect tariffs, for comparison with the 2011 data.

(6) The churn rate is calculated at the ratio of subscribers who disconnected from the company's services and subscribers who became inactive during the period, to the average number of active subscribers during the period. After adjustment for eliminated subscribers (see comment 7 below), the churn rate for 2011 is 19.4%.

(7) Due to increased movement of subscribers to pre-paid tracks in the initial months after reduction of the exit penalties, Pelephone decided not to include subscribers who had made no outgoing calls during the fourth quarter in the number of active subscribers. As a result, Pelephone deducted 91,000 subscribers. These subscribers were deducted retrospectively from each quarter in which they were moved to the pre-paid tracks. Consequently, figures for subscribers, ARPU, MOU and churn rates were corrected retroactively in each quarter.

The competition in the sector increased in 2011 due to regulatory changes that simplified the mobility of subscribers between cellular companies. This led to erosion in income and an increase in churn rates. After adjustment for the effect of the reduction in interconnect fees on the average monthly income per subscriber declined by 3.6% in 2011, and this alongside an increase in the use of services was reflected in an increase in the average monthly usage of minutes per subscriber, a significant increase in the use of data communications and an increase in the use of content services provided by Pelephone. The churn rate increased from 15.3% in 2010 to 22.9% in 2011.

The lively movement of subscribers in the cellular market and the increased demand overall for handsets and particularly for smartphones have helped increase revenues from terminal equipment, which in 2011 were NIS 1.9 billion and represented 34.4% of total revenues, as against revenues of NIS 1.2 billion, representing 20.6% in 2010. Payment for terminal equipment is generally made in 36 monthly installments, and in view of the increase in sales of terminal equipment, there has been an increase in the balance due from Pelephone customers and a deterioration in cash flows from current operations. This has been exacerbated by the increasing popularity of smartphones that carry higher purchase prices.

Products and Services

Pelephone provides its subscribers with a comprehensive offering of voice transmission, transmission of text messages, data communications and advanced multimedia services. Pelephone also offers its customers various packages and tracks that combine basic voice services, added value services, repair services and warranties for cellular handsets. Pelephone gives its customers discounts on service prices, depending on the type and price of terminal equipment that the subscriber has, as well as other benefits.

Basic telephone services (voice). Pelephone’s service package includes basic call services, call completion services and auxiliary services such as call waiting, call forwarding, voice mail, voice conference call and caller ID.

Value added services. Pelephone offers its customers value added services such as Internet surfing, text messaging and information services using SMS (text), multimedia MMS messages, voice information services using special purpose asterisks, information and entertainment services through as Internet portal. Pelephone’s value added services also include the ability to watch various television channels, such as music, sports, news and entertainment channels, and the ability to photograph and forward video files. Pelephone also offers services such as Internet surfing from a laptop through a cellular modem.

Roaming services. Pelephone provides roaming services (communications by means of cellular handsets from different locations around the world) in accordance with agreements it has with cellular operators abroad, enabling Pelephone to access their networks. Roaming service agreements are based on a standard document recommended by the GSM Association, which in addition to the basic contract also includes a Common Annex and Individual Annex. The Common Annex defines the operating procedures agreed upon by two operators. The Individual Annex defines operating and commercial parameters for each operator separately. Few changes are generally made in the standard text. The roaming tariffs are defined in the Individual Annex. In some cases, operators negotiate the tariffs, and this requires a signature on a special, separate annex which includes the agreed tariffs. Pelephone is able to offer customers utilizing UMTS/HSPA handsets roaming services using their personal handsets in 212 countries. Pelephone also provides incoming roaming services for the customers of foreign operators while they are in Israel.

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

Handsets. Pelephone offers its customers various types and brands of cellular telephones, on-board telephones and hands-free devices, as well as support for its range of services. Pelephone also supplies its customers with modems and laptop computers for surfing the Internet through the Pelephone network.

Cellular technologies used by Pelephone

Pelephone currently operates communications networks utilizing two principal technologies:

- UMTS/HSPA, a digital technology based on the GSM standard, which developed in the 2.5 generation to GPRS, in the third generation to UMTS, and in the 3.5 generation to HSPA. This technology is globally widespread, and enables subscriber identification and the provision of service by means of a SIM card, which can be transferred from one handset to another. Pelephone began to operate the UMTS/HSPA network in 2009 and in May 2010 an upgrade for UMTS/HSPA was launched – HSPA+. Among the advantages of this technology are is support for download speeds of up to 21 Mbps and upload speeds of up to 5.7 Mbps. In December 2011, the network was upgraded to a maximum download speed of 42 Mbps.

- CDMA digital technology, which is less widespread than UMTS/HSPA and in which subscriber identification is by the identification of details burned onto a subscriber's terminal equipment rather than by means of a SIM card. The CDMA network was Pelephone's only network until 2009 and it operates nationwide and enables speech, data communication and value added services.

Pelephone currently operates the two networks in parallel and constantly reviews new technologies and the need to upgrade its existing network technologies, depending on competition and the economic viability of the investment.

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

Since the UMTS/HSAP network was launched, Pelephone is working to transfer existing subscribers from CDMA to UMTS/HSPA, and offers them an upgrade of their handsets to the new network. It is not increasing its investments in the CDMA network beyond the needs of current maintenance.

Engineering infrastructure such as buildings, masts and general infrastructure serve both the CDMA network and the UMTS/HSPA network. As of the date of this annual report, Pelephone's UMTS/HSPA infrastructure is based principally on two switch farms and the CDMA network is based on three switch farms. The network centers are connected to approximately 2,100 sites.

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Pelephone has continued to expand its UMTS/HSPA network service after its launch. In 2010 Pelephone gradually upgraded the network to support a higher data communication capacity on HSPA+ technology. At the end of 2011, a new agreement was signed with Ericsson to significantly expand network capacity, mainly with respect to sites in areas of heavy use. Investments in 2012, including a significant enlargement of network capacity are projected to be consistent with Pelephone's expenditures in 2011.

The cellular communications market is dynamic and is characterized by frequent technological changes in all its areas of operation (handsets, network technology and value added services). These changes impact the segment of operation on a number of levels: technological developments in terminal equipment and the desire to widen the range and quality of the services offered to the customer require cellular operators to periodically upgrade their network technologies.

The penetration of Smart phones, cellular phones with integrated operating systems allowing the use of advanced applications, has led to a rise in the consumption of data transfer services while increasing the supply of alternative applications and services to the Pelephone products and services provided by other entities. Technologies that enable voice telephony and Internet (data) services in a VoC network could compete with Pelephone's services and materially affect its operations in the future.

A new technology known as Long Term Evolution, or LTE, is currently in the initial stages of application in several countries as a data transfer, not a voice, network. This technology is based on an IP that can transfer data at higher speeds than the existing Generation 3.5 technology. The supply of handsets and applications compatible with LTE technology are still very limited. The Ministry of Communications has not yet formulated a policy for the designation and allocation of a frequency range for LTE technology use in Israel. Such a policy, as well as technological developments in this area could have a significant effect on Pelephone.

In 2011, Pelephone continued to improve and broaden the range of its value added services and increase the number of subscribers using those services.

Standards

Pelephone conducts routine durability and quality control tests of its facilities. Pelephone complies with the requirements of Israeli Standard ISO 9001, 2008 version for mobile radio telephone (cellular) services and it undergoes periodic inspections by the Standards Institute of Israel to confirm compliance with the standard. The current certification is valid until December 2013. An annual inspection is conducted to ensure that Pelephone's operations comply with the requirements of the standard. The last inspection was in December 2011, and was successful.

The following table provides a breakdown of Pelephone's revenues by product and service for the three years ended December 31, 2011:

	2009		2010		2011	
			(in NIS millions)			
Revenue from services (1)	4,256		4,550		3,637	
Percentage of total revenue	79.2	%	79.4	%	65.6	%
Revenue from terminal equipment	1,120		1,182		1,911	
Percentage of total revenue	20.8	%	20.6	%	34.4	%
Total revenue	5,376		5,732		5,548	

(1)

Revenue from services includes revenues from cellular services (airtime, usage fees, call completion fees, roaming fees, value added services and others), and revenues from repair services and warranty.

The following table provides a breakdown of Pelephone's revenues from value added services for the three years ended December 31, 2011:

	2009	2010	2011
		(in NIS millions)	
Revenue from content and data services	539	725	852
Revenue from SMS (text)	240	289	349
Total revenue from value added services	779	1,014	1,201

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Competition

There are currently four operators in the Israeli cellular market and one virtual operator. Over the years, intense competition has developed among the cellular operators (mainly among Pelephone, Cellcom and Partner). The competition has led to saturation in the market, evidenced by smaller numbers of new subscribers, increased switching of subscribers between cellular companies and erosion of the prices that the cellular operators, including Pelephone, collect from their customers for the services provided.

The table shows, to the best of Pelephone's knowledge, the number of subscriber serviced by each of the four cellular operators at December 31, 2010 and September 30, 2011 in thousends of subscribers.

		Pelephone	Partner	Cellcom	Mirs (1)	Total in market
At Dec. 31, 2010	No. of subscribers (2)	2,857	3,160	3,394	491	9,902
	Market share	28.9%	31.9%	34.3%	5.0%	
At Sep. 30, 2011	No. of subscribers (2)	2,842	3,201	3,391	490	9,924
	Market share	28.6%	32.3%	34.2%	4.9%	

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

(2) The numbers of subscribers are at September 30, 2011 and December 31, 2010, based on the reports of Cellcom and Partner to the public.

Due to increased movement to pre-paid tracks in the initial months after reduction of the exit penalties, Pelephone decided not to include subscribers who had not made outgoing calls during the last quarter in the numbers of active subscribers. As a result, Pelephone deducted 91,000 subscribers. These subscribers were deducted retrospectively from each quarter in which they were transferred to the pre-paid tracks. Consequently, the market segments and data on Pelephone's subscribers were corrected retroactively at September 30, 2011.

The entry of new operators with infrastructure and MVNOs, as well as regulatory initiatives intended to encourage customers to switch among operators, are expected to increase the competition in the market in the near future.

Pelephone's principal competitors, Cellcom and Partner, also provide Internet access services (ISPs) and domestic communications, and they market diverse joint service packages.

Pelephone anticipates that the entry of the new operators will intensify competition in the cellular market. The main implications of competition in the cellular market are price erosion, a higher churn rate, an increase in the cost of enlisting and preserving subscribers, and the need to increase investment in infrastructure in order to be competitive. Nevertheless, is not certain how the entry of new operators or more intense competition will affect Pelephone.

Customers

At the end of 2011, the number of Pelephone subscribers was 2,847,000, of which approximately 65% are private customers and 35% are business customers.

The table below provide the amount of Pelephone’s revenue from customers in each of the three years ended December 31, 2011 (in NIS millions):

	2009	2010	2011
Revenues from private customers	2,751	2,899	2,985
Revenues from business customers	2,625	2,833	2,563
Total revenue	5,376	5,732	5,548

Some of Pelephone's customers are pre-paid customers (who pay for communication services in advance). Revenues from these customers are not material to the Pelephone’s total revenues.

Marketing

Pelephone's distribution system is based on 41 service and sales centers, including facilities throughout Israel, which provide service, customer sales, repairs or provision of substitute handsets while a handset is under repair, installation of handsets, and customer retention. The distribution system is reinforced with stores and stands at 94 points of sale, some of which are operated by Pelephone employees and others by authorized dealers. In addition, Pelephone utilizes dealers who operate a door to door system, and service and sales representatives for the business sector. As a rule, payment to the dealers is in the form of a commission on sales.

Pelephone's subscriber service system includes the company's website and 17 designated telephone call centers that provide information, service on various matters, technical support, data on customer billing, value added services, sales and general information in three languages.

Seasonality

In the past, the revenues of the second and third quarters were typically slightly higher than in the first and fourth quarters. In view of the shift to marketing packages that include fixed usage fees, there is no longer any seasonal effect.

Governmental Regulation

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Services, which is valid until 2022. The operating license prescribes conditions and rules that apply to Pelephone's operations, which conditions and rules are subject to amendment. In April 2001, the Civil Administration for the Judea and Samaria Region awarded Pelephone a general license for the provision of cellular services in the region of Judea and Samaria. The provisions of the general license awarded to Pelephone by the Ministry of Communications are generally applicable to this license.

As part of the approval of the merger of Bezeq and Pelephone on August 26, 2004, restrictive terms were imposed, mainly prohibiting discrimination in favor of Pelephone in the supply of a product in which Bezeq holds a monopoly, prohibiting the bundling of the supply of certain products by either of the companies when purchasing products or services from the other and limitations on certain joint activities. On October 10, 2010, the terms of the merger were amended by removing certain restrictions, and in particular the sweeping ban on joint marketing of Bezeq's and Pelephone's services. Nevertheless, the conditions include certain restrictions on the joint marketing of services.

Regulatory changes in the cellular market

Over the past few years, the Ministry of Communications has promoted various regulatory actions to increase competition in the cellular market, which have materially impacted the structure of the market and the competition in it.

Additional operator licenses

During 2011, a tender was issued to grant frequencies and licenses for cellular operators that own infrastructure. The tender was awarded to Mirs (part of the HOT-Mirs Group) and Golan Telecom Ltd., or Golan. Under the tender conditions, the winners will be able to launch their activity after they have deployed a cellular network that initially covers 10% of the population of the State of Israel. Following this deployment, the new operators will be able to utilize the existing operator networks for a period of up to 7 years (with a possible extension based on approval for three more years), and based on the national roaming model. According to the tender, Mirs will pay NIS 710 million and Golan will pay NIS 360 million in license fees at the end of 5 years. Such license fees will be reduced by one seventh (about 14.3%) for every 1% market share accumulated in the private sector over a five-year period from the date of granting the license, so that if a new operator manages to gain 7% of the private market, it will not pay any license fees.

In July 2011, the Ministry of Communications issued a press release listing the following main recommendations of the inter-ministerial committee on "the sharing of infrastructures in the cellular market”:

- A model of forced sharing of sites will be defined, giving preference to the possibility of involving the new operators;
- Obtaining a permit to set up a site will be conditional on a proposal for cooperation for all operators:
- The operators will be obligated to erect sites that facilitate sharing with up to four participants;
- All the components and infrastructures used for broadcasting from the facility will be shared, excluding active designated equipment (radio equipment);
- That the costs of sharing sits be shared; and.
- All license holders will be encouraged and obligated to reduce the number of unshared sites each year.

If the recommendations are enacted into legislation, they may impose significant restrictions on Pelephone's ability to expand its network. Pelephone has written to the State Attorney, submitting its reservations, which focus on the requirement to reduce the number of existing sites that are not shared and the economic model for the sharing of costs, whereas new participants in existing sites will only be required to bear their share of the "adjustment costs" and not the full costs of erecting the site.

Domestic roaming agreements

In November 2011, Pelephone signed an agreement with Mirs to provide domestic roaming services and share infrastructure on its UMTS/HSPA network. The agreement term is until December 31, 2014 and is subject, if required, to approval from the Antitrust Commissioner. The necessary applications have been made to the Antitrust Authority. In October 2011, Cellcom announced that it had signed a domestic roaming services agreement and an agreement to share infrastructure with Golan. Pelephone expects the new cellular networks of Mirs and Golan to begin operating during 2012, further intensifying competition in the cellular market.

Mobile Virtual Network Operator – MVNO

A MVNO is a cellular operator that does not own a cellular infrastructure and uses the network of another cellular operator to provide its customers with the service, where the extent of use of the resources of the existing operator can vary among MVNOs. The Ministry of Communications completed its policy on MVNOs and granted licenses to eight companies. As of the date of this annual report, Rami Levy Communication Ltd., which entered into a usage agreement with Pelephone, is the only active MVNO and other entities have submitted applications for MVNO licenses. Pelephone believes that while the entry of MVNOs will increase competition in the cellular market, it will benefit from an additional source of income if it enters into agreements with some or all of the other MVNOs.

Separation of cellular Internet infrastructures and the ISP

At a hearing in August 2009, the Ministry of Communications sought ways to separate the provision of access to broadband infrastructure from connection to the Internet, similar to the separation in the fixed-line network. Pelephone currently provides both services in the manner accepted all over the world. As of the date of this annual report, no progress has been made on the subject since the hearing.

Reform of exit penalties

In an amendment to the Communications Law made as part of the Arrangements Law, commencing February 1, 2011, the amount that can be collected from a cellular subscriber upon termination of the agreement before the end of the commitment period was limited to 8% of the average monthly bill for services consumed during the term of the agreement, multiplied by the number of months remaining under the commitment. The amendment applies for all customers except those with more than 50 lines and who entered into an agreement with the operator before January 1, 2011, and those with more than 100 lines who entered into an agreement with the operator after January 1, 2011. The amendment also prohibits the operator, upon cancellation of the agreement by the subscriber, from demanding immediate repayment of the balance of the subscriber's outstanding obligation for terminal equipment. The limitation of these penalties led to further easement of the barriers to switching operators and to increased competition, reflected in an increase in the churn rate. In order to mitigate the increase in the churn rate, cellular carriers have increased their focus on retention activities, which has resulted in lower revenues.

On March 21, 2012, the Knesset passed a bill whereby exit penalties for new customers will be completely eliminated. According to the bill, elimination of the exit fees will apply to private customers and to business customers that have up to 100 phone lines and entered into agreements beginning on November 1, 2011. Pelephone believes that the elimination of exit penalties in full will not significantly affect the market beyond the impact arising from the restrictions on exit fees that were introduced at the beginning of 2011.

Network neutrality

Under the Arrangements Law, a license-holder may not restrict or block the: (i) use of any service or application provided over the Internet; (ii) features or characteristics of cellular terminal equipment; or (iii) use of cellular terminal equipment in any public telecommunications network.

In March 2012, as part of the bill to abolish exit penalties, the Knesset passed a further amendment to the Communications Law, whereby as of January 1, 2013, a cellular operator will be prohibited from linking between telephony and cellular services and selling or renting terminal equipment in any way, including giving a subscriber benefits or discount on cellular services that is dependent on the purchasing of terminal equipment. The abolishment of the ability to provide discounted cellular services to customers who buy certain terminal equipment may materially impact Pelephone’s revenues from selling such equipment.

Other legislative amendments

Commencing in 2011, terminal equipment that is locked for use by a specific cellular network may no longer be sold. For customers who entered into an agreement with an operator before January 1, 2011, the Arrangements Law states that no payment will be collected from them by the operator for opening a locked SIM card to enable them to use the terminal equipment they purchased from one operator when they switch to another operator. The law also contains provisions for liberalization of the rules relating to the import of terminal equipment.

Statutory provisions relating to the environment that are applicable to Pelephone's operations

The broadcasting sites used by Pelephone are "sources of radiation" as defined in the Radiation Law. The erection and operation of these sites, excluding those listed in the Schedule to the law, requires a radiation permit. The law incorporates a two-step licensing mechanism: the applicant first requests a permit to construct a radiation source, or the Erection Permit, which remains in effect for no more than three months and can be extended by the commissioner for up to nine months; and then a permit to operate the radiation source, or the Operation Permit, which remains in effect for five years or as otherwise determined by the Minister for Protection of the Environment, taking into consideration the type of radiation source or its location.

The provision of an Erection Permit is contingent on an assessment of the maximum radiation levels to which human beings and the environment are expected to be exposed from the radiation source, including in the event of a malfunction, and on implementation of the measures needed to limit the exposure levels of human beings and the environment to the radiation expected from the radiation source, including implementation of technological means that are in use, or the Limiting Measures.

The grant of an Operation Permit is contingent upon the implementation of the Limiting Measures and to measuring the exposure levels of human beings and the environment to the radiation generated when operating the source of radiation, in an amount not to exceed the maximum exposure levels set by the Commissioner. The grant of the Operation Permit is also contingent upon presentation of a license under the Communications Law and presentation of a permit pursuant to the Planning and Construction Law, except when a building permit is not required, in which case the law directs that the applicant submit a statement to the local committee specifying the reasons that a building permit is not required for the source of radiation. If the local council engineer or district planner does not object to the grant of the Operation Permit within 21 days from the day the statement is submitted, the applicant must submit an additional statement stating that the aforementioned period has passed and no such objection has been made.

The law includes punitive provisions which provide in part that the construction or operation of a source of radiation in contravention of the provisions of the permit and the construction or operation of a source of radiation without a permit, after a warning in writing is given by the Commissioner, are strict liability offenses.

A small number of city engineers have acted according to the mechanism provided in the law and have announced that in their opinion, a particular access facility requires a building permit, and have objected to the grant an Operation Permit for that facility.

The law also indirectly amends the Planning and Construction Law and provides that a building permit for a cellular broadcasting facility is contingent on the deposit of an indemnity note in respect of claims for compensation pursuant to Section 197 of the Planning and Construction Law, providing that such claim is in accordance with the directives of the National Council. The Minister for Protection of the Environment also promulgated regulations pursuant to the Radiation Law ("the Regulations") that address issues such as fees for permits, the method of measuring radiation, etc.

In January 2009, the Radiation Supervisor at the Ministry for Protection of the Environment published guidelines regarding safety ranges and maximum permitted exposure levels with respect to radio frequency radiation, including from cellular aerials.

The drawn-out promulgation of the regulations required by Radiation Law also led to a petition to the Supreme Court, under which an order was issued on June 27, 2010 ordering the Minister for Protection of the Environment and the Minister of Communications to explain why the proposed regulations should not be submitted immediately for approval by the Knesset's internal committee for environmental quality. On October 20, 2010 the proposed wording of the regulations was placed before the committee. On January 18, 2011 the committee held a discussion on the request from the Minister for Protection of the Environment to approve the regulations. On February 7, 2011, the Supreme Court ruled that as of recent developments in the legislation process the petition is moot and ordered its dismissal.

On May 31, 2011, the World Health Organization's International Agency for Research on Cancer (IARC) published an announcement to the effect that radiofrequency electromagnetic fields associated with the use of mobile phones may be carcinogenic to humans.

As part of the policy of the Ministry for Protection of the Environment to increase its law enforcement capabilities, commencing on August 25, 2010 the Ministry embarked on a pilot project for the continuous supervision and monitoring of broadcasting centers, which is now fully operational. This is not external monitoring of the strength of the radiation emitted by the radio broadcasts from the base sites, but, using computer recordings from the control system in the broadcasting sites and examining them to verify the relevant broadcasting data in accordance with the system. In this context, the Minister for Protection of the Environment announced on August 22, 2010 the addition of two conditions to Pelephone's erection and operation permits whereby, among other things, a continuous real-time computer report of all the parameters setting the radiation level created during operation of the radiation source should be sent to the Radiation Supervisor and disruptions in the operation of the software and the transfer of data to the Ministry for Protection of the Environment are prohibited.

Cellular services are provided by means of a cellular phone which emits non-ionizing radiation (also known as electromagnetic radiation). Consumer Protection Regulations (Information regarding Non-Ionizing Radiation from a Cellular Telephone) 2002, specify the maximum permitted radiation level for a cellular phone measured in units of Specific Absorption Rate, or SAR, and informing Pelephone's customers accordingly. As far as Pelephone is aware, all the cellular phones that it markets comply with the relevant SAR standards.

Pelephone conducts periodic radiation tests in order to ascertain its compliance with permitted operation standards and the standards of the International Radiation Protection Agency. These tests are outsourced and performed by companies authorized by the Ministry for Protection of the Environment. Pelephone invests an average of NIS 4.5 million per year in this operation. The radiation regulations require payment of fees amounting to approximately NIS 4 million for the granting and renewal of the permits required under the Radiation Law.

Pelephone has an internal enforcement procedure for supervision of implementation of the provisions of the Radiation Law, which is supervised by a senior manager. The purpose of the procedure is to incorporate the provisions of the law into the procedures of Pelephone and limit the possibility of violations.

Transparency for consumers

Pelephone is subject to relevant laws that define obligations to publicize and inform customers about the sources of the radiation that it operates and the mobile handsets that it supplies. The Radiation Supervisor at the Ministry for Protection of the Environment publishes information on the Ministry's website about active cellular broadcasting facilities and those that are under construction. The Ministry for Protection of the Environment continuously monitors the cellular broadcasting facilities that Pelephone erects and operates, as it does to the other operators. On its website, Pelephone publishes information about radiation emitted from cellular phones and Ministry of Health regulations regarding preventive caution when using cellular phones.

Communications Law and the cellular license

Pelephone's provision of cellular services is subject to the provisions of the Communications Law and its regulations. The law authorizes the Director General of the Ministry of Communications to impose financial sanctions for various breaches of the provisions of the law and ordinances and provisions by virtue thereof, and for breaches of the terms of the permit.

Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance regulates the use of the electromagnetic spectrum, and applies, inter alia, to Bezeq's use of radio frequencies, as part of its infrastructure. Under the Telegraph Ordinance, the establishment and operation of a system using radio frequencies requires a license, and the use of radio frequencies requires designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies. For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel, by limiting the number of licenses issued for the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of frequencies on the other. The shortage of frequencies may cause difficulties in implementing certain technologies.

In July 2011, the Ministry of Communications refunded NIS 41.4 million to Pelephone in respect of frequency fees that it had overpaid during 2008, while exercising the right to use 3-G frequencies. When utilizing this right, Pelephone was required to pay the fee for the period from 2003 until 2008 when it exercised its right. The Ministry of Communications based the charge on the maximum frequency tariff prescribed in the regulations as of 2003. During the course of legal action taken by Cellcom and Partner, it was determined that the Ministry of Communications must charge the companies a reduced tariff, gradually increasing from year to year, and charge the maximum tariff beginning after the fifth year (2008).

Tariffs

The interconnect fees (call and text message (SMS) completion fees collected by Pelephone from other operators) are fixed in the Interconnect Regulations, which set the interconnect tariffs to be paid to domestic carriers, as well as limitations on the interconnect tariffs to be paid to a cellular operator. The other tariffs collected by Pelephone from its customers are not controlled, but the types of payments it can collect from its subscribers and the mechanisms for setting regulated tariffs, are regulated in the license.

In September 2010, the regulations were amended so that commencing January 1, 2011, the interconnect tariffs that a cellular carrier could collect from other operators (domestic carriers, international call operators or other cellular operators) were lowered significantly. The tariffs, which are denominated in agorot (100 agorot are equal to 1 NIS), will be revised every year on January 1, and linked to the index (the base index being the average CPI for 2009), and both VAT and the rate of royalties applicable to cellular operators multiplied by the indexed interconnect tariff, will be added.

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Below are the interconnect tariffs in agorot for a cellular operator as of December 31 of each year, which do not include VAT and are calculated at the royalties rate agreed upon by the government and the Supreme Court. If the reduction of royalties is not approved in the near future, Pelephone may update the interconnect tariffs according to a high royalties factor (approximately 2.5%):

	2010	2011	2012	2013	From 2014 onwards
Call minute completion tariff	25.1	7.28	6.89	6.31	5.93
SMS (text) completion tariff	2.85	0.17	0.16	0.15	0.14

Bezeq charges its fixed-line customers interconnect fees for calls originating in Bezeq's network and terminating in the cellular networks, and pays the cellular operators the same amount for transferring call traffic from their network.

The table below indicates interconnect revenues Bezeq received from its fixed-line domestic subscribers and its expenses for call completion fees to the cellular companies in the three years ended December 31, 2010 (in NIS millions):

	2009	2010	2011
Revenue, net	823	801	256

Pelephone pays the other cellular operators interconnect fees for calls originating in its network and terminating in their cellular networks, while the other operators (cellular, domestic and international) pay Pelephone interconnect fees for calls terminating in its cellular network.

The table below indicates Pelephone’s interconnect revenues from the other communications networks in respect of incoming text messages (SMS) to its network, and its expenses in respect of interconnect fees paid to the other cellular networks in 2009 – 2011 (in NIS millions):

	2009	2010	2011
Revenue	920	1,054	343
Expenses	707	813	265

The figure is calculated according to the relevant minutes and SMS actually used/transmitted in the previous period, multiplied by the difference between the interconnect fees in the present period (7.28 agorot per minute, 0.17 agorot per SMS) and the interconnect fees in the corresponding period (25.1 agorot per minute, 2.85 agorot per SMS).

In the international calls segment (Bezeq International) – Bezeq International pays interconnect fees to the cellular operators for calls terminating in their cellular networks. The reduction of the interconnect fees resulted in a decline of approximately NIS 218 million in Pelephone's gross profit in 2011. The impact of the lower interconnect fees was minor and not material for Bezeq and Bezeq International.

Site licensing

Pelephone’s cellular service is provided through cellular sites spread over Israel in accordance with engineering requirements. The constant need to upgrade and improve the quality of the cellular services necessitates setting-up cellular sites and changes in configuration and existing antenna systems. Pelephone deploys two mains types of broadcasting sites: macro sites that require a building permit from planning and building councils and wireless access devices (access devices), which are exempt from a building permit.

The licensing of cellular broadcasting sites that require building permits is governed by National Outline Plan 36, or NOP 36. The purpose of NOP 36, which came into effect in 2002, is to regulate the deployment and manner of setting-up broadcasting facilities, so that the entire country is covered for transmission and reception, with minimal damage to the environment and the landscape. Pelephone and its competitors have encountered difficulties in obtaining some of the required approvals, and in particular approvals from planning and building authorities. There is a pending proposal to amend NOP 36, which may result in more stringent regulations that could complicate and impede the process of obtaining building permits for cellular sites. Pelephone is aware of an initiative to appoint a joint technical consultant to the Ministry of the Interior and the Ministry of Communications to assist in the review the proposal to amend NOP 36.

Pelephone's ability to maintain and preserve its cellular service quality as well as its coverage, is partially dependent on its ability to set up cellular sites and install infrastructure equipment, including broadcasting sites. Any difficulties encountered by Pelephone in obtaining the required permits and approvals may adversely affect the performance of its existing network and the establishment of additional cellular sites required by the network. The inability to resolve these problems on a timely basis may prevent Pelephone from attaining the service quality goals specified in its license.

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the Israeli Defense Forces, even though the applications for the approvals have long since been submitted to them. Similarly, there are administrative or other delays in some planning and building councils in the issue of building permits for sites. Therefore, Pelephone is operating a number of broadcasting sites that have not yet received building permits. Pelephone has applied to the planning and building authorities for the building permits and these applications are at various stages of discussion and approval.

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

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

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

Pelephone establishes broadcasting sites using access devices. Access devices require specific radiation permits according to the radiation law but are exempt from a building permit if they are constructed pursuant to the conditions provided in the exemption provision. Some local authorities have disputed the applicability of the exemption provision to access devices of a cellular network and to their use. Pelephone's position regarding the applicability of the exemption was accepted in a number of rulings and decisions by local courts and the use of such facilities and the supporting equipment were approved. One verdict provided an opposite ruling. Appeals have been filed for some of these rulings and decisions.

Pelephone's cellular licenses

Pelephone's general license is valid until September 8, 2022. In addition, in April 2001, the Civil Administration for the Administered Territories granted Pelephone a general license for the provision of cellular services in the Administered Territories that is valid until October 30, 2012 and the provisions of the general license granted to Pelephone by the Ministry of Communications are also applicable to this license. The following are the principal provisions of Pelephone's general cellular license:

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

The license is non-transferable, and it contains restrictions on the acquisition or transfer (including by means of a charge), directly or indirectly, of control or of 10% or more of any means of control in Pelephone, including an encumbrance on such means of control, unless the Minister has given his consent beforehand.

- Pelephone is obliged to provide an interconnect service under equal terms to all other operators and it shall refrain from any discrimination in the implementation thereof.

- Pelephone must refrain from giving a preference in providing its infrastructure services to a licensee with an interest (as defined in the license), such as a related party, over another licensee.

- Pelephone is generally not entitled to sell, lease or mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for certain deviations stipulated in the license.

- In periods of emergency, whoever is statutorily competent shall have the authority to issue Pelephone with certain instructions on its mode of operation and/or manner of provision of services.

- The license sets forth the types of payments that Pelephone can collect from its subscribers for cellular services, mechanisms for setting tariffs, reports that Pelephone must submit to the Ministry of Communications and also the duty of serving notice to the Ministry of Communications prior to modifying tariffs. The license also determines the Minister’s power to intervene in setting tariffs in certain cases.

- The license commits Pelephone to provide a minimal standard of service, including setting up of service call centers, the determination of a maximum period for repair of malfunctions, an accounts collection procedure and protection of the privacy of the recipient of the service.

- To secure Pelephone's undertakings and to compensate and indemnify the State of Israel for any damage caused by acts committed by Pelephone, Pelephone is required to furnish a bank guarantee of $10 million, which is subject to forfeiture.

Changes to Pelephone's license

In December 2010, the Ministry of Communications published wide ranging amendments to the cellular licenses relating to a variety of consumer issues. Such amendments affect Pelephone’s relationship with its customers and impose a number of record keeping changes in addition of the obligation to actively notify customers regarding their package usage.

Products and Suppliers

Terminal equipment suppliers

The product inventory of Pelephone includes a range of cellular telephone units, auxiliary accessories (such as batteries, hand-free kits, earphones, data cables and chargers). Pelephone also maintains spare parts to supply repair services to its customers and an inventory of used handsets.

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

If a contract with a particular terminal equipment supplier is discontinued, Pelephone may increase the quantity purchased from other terminal equipment suppliers or procure terminal equipment from a new terminal equipment supplier. If the replacement of a supplier is required, the replacement will not be immediate, and will be subject to a special preparatory period for purchasing spare parts and accessories, including the repair capacity for all kinds of malfunctions, to enable the provision of service to customers as agreed.

In preparation for migration to HSPA/UMTS technology, Pelephone expanded the range of equipment it offers to customers and the number of its terminal equipment suppliers from whom Pelephone purchases handsets, spare parts, accessories, etc.

In May 2009, Pelephone signed an agreement with Apple Sales International for the purchase and distribution of iPhones in Israel. In 2011, Pelephone's purchases from Apple accounted for 19% of its purchases from all its suppliers. Accordingly, Apple is considered a principal supplier of Pelephone. Other than with respect to the iPhone, the purchase of terminal equipment from suppliers does not create any significant dependence on any particular equipment supplier or model.

An agreement between Pelephone and Eurocom Cellular (a company indirectly controlled by Mr. Shaul Elovitch), the Israeli distributor of Nokia terminal equipment, regulates the purchase and supply of Nokia products to Pelephone and the maintenance services for those products through December 31, 2012. The agreement was approved by the general meetings of Pelephone and of Bezeq, as a transaction in which the controlling shareholder in Bezeq has a personal interest.

Value added service suppliers

Pelephone has agreements with suppliers for content such as information services by voice, SMS or Pelephone's portal, games, animations, ring-tones, location services, content and the rights to broadcast over third generation technology. As is usual in this industry, a large portion of these agreements are based on a model of dividing revenues between Pelephone and the content suppliers for the services provided to customers. Termination of contracts with certain suppliers might cause delays in supplying some of the services pending contracting with substitute suppliers.

Infrastructure suppliers

The infrastructure equipment needed for the UMTS/HSPA network is produced by Ericsson and the infrastructure equipment for the CDMA network is produced by Nortel and Motorola. Pelephone has long-term agreements for the maintenance, support and upgrading of software for the UMTS/HSPA network and a maintenance agreement with Ericsson for the Nortel network. In the opinion of Pelephone, it could become dependent on Ericsson in connection with support for this network. Pelephone maintains the Motorola equipment independently. In addition, the cellular network uses transmission facilities for which Bezeq is Pelephone's main supplier.

Software, computer systems and databases

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

Property

Pelephone does not own any land and leases the premises which it uses for its operations from others, including Bezeq. The land which Pelephone uses for installation of radio and switching sites are spread out around the country, and are leased for various periods (in many instances, for five years plus an option to extend the agreement for another five years). Pelephone's headquarters are located in Givatayim, a suburb of Tel Aviv, and cover a total area of 17,800 square meters. The lease for these premises expires on December 31, 2015 and there is an option to extend the lease until November 2020. For the purpose of service and sale operations, Pelephone leases 58 service and sale centers spread out around the country. Pelephone has additional lease agreements with respect to warehouses, offices and telephone call centers which it uses for the purpose of its operations.

Some of the leased communications sites are in areas owned by the ILA. Pelephone entered into an agreement with the ILA to use land in those areas for the erection and operation of communications sites. Among other things, the agreement regulates payments to which the ILA is entitled for the period to December 31, 2008. At the end of the term of the agreement and in the event of its cancellation for causes listed in it, Pelephone must vacate the site. To the best of Pelephone's knowledge, the other cellular operators have a similar agreement with the ILA. The agreement was extended to December 31, 2009, and subsequently to December 31, 2010. As of the date of this annual report Pelephone, and to the best of its knowledge the other cellular operators, are negotiating extensions. If for any reason the agreement is not extended or renewed, Pelephone could suffer significant harm, since it would be limited in its ability to erect sites in ILA property.

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Employees

The table below provides data with respect to the number of Pelephone employees at December 31, 2010 and 2011.

	2010	2011
Management and HQ	269	279
Content and product marketing	93	96
Service – Private customers	2,432	2,206
Business customers	561	533
Operation and logistics	287	344
Engineering and information systems	605	583
Total	4,247	4,041

BEZEQ INTERNATIONAL

General

Bezeq International provides communication solutions to its customers in the private and business sectors, in four key areas of operation: (i) Internet access services; (ii) international and domestic telephony services; (iii) network end point, or PBX, services; and (iv) information and communication technology, or ICT, solutions.

The following table reflects Bezeq International's revenue (in NIS millions) for the three years ended December 31, 2011:

	2009		2010		2011	
Revenues from international carrier services	502		501		413	
% of total revenues	38.10	%	36.30	%	30.51	%
Revenues from Internet and communication services for businesses (ISP, ICT, data)	816		879		941	
% of total revenues	61.90	%	63.70	%	69.49	%
Total revenue	1,318		1,380		1,354	

	2010		2011	
Revenues	1,380		1,354	
Operating profit	320		241	
Depreciation and amortization	94		109	
Operating profit before depreciation and amortization	414		350	
Net profit	254		182	
Cash flow from current activities	292		243	
Payments for investments in property, plant and equipment and intangible assets(1)	180		288	
Free cash flow (2)	112		(45	)
Churn rate (3)	12.7	%	12.6	%

(1) The item also includes long-term investments in long-term assets.

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

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

Developments in 2011

In 2011, there was a continued slow-down in the growth rate of high-speed Internet compared to previous years, while the upgrade of the Internet infrastructure in Israel by Bezeq and HOT continued, marked by the availability of a range of speeds from 10MB through 100MB on Bezeq's NGN network and HOT's UFI network (DOCSIS 3.0).

In addition, in 2011, the trend of selling service bundles continued as did the trend for increased sales of value-added services. This has led to market saturation (approximately 73% of Israeli households are connected to the Internet), with competitors attempting to differentiate themselves by strengthening customer loyalty.

As a rule, an increase in demand for a higher bandwidth requires an increase from time to time in the capacity operated by Bezeq International. In January 2012, Bezeq International launched its Power NGN network, a high-speed Internet access network which relies on the advanced technology capabilities of the new submarine cable that it owns, or the Jonah Cable, together with new state-of-the-art core and access systems.

Customers

Bezeq International has no customer whose revenues constitute over 10% of its revenues. Below is a breakdown of revenues (in NIS millions) from private and business customers:

	2009	2010	2011
Revenues from private customers	520	523	540
Revenues from business customers	798	857	813
Total revenues	1,318	1,380	1,354

Products and Services

Voice services

In the voice services sector, Bezeq International provides international direct dialing, or IDD, services to business and private customers; toll-free number services for business customers overseas; international call routing and termination services (hubbing) – transfer of international calls between foreign communication providers (worldwide), calling card services enabling prepaid and postpaid dialing from and to Israel, for business and private customers; and the 1809 service for dialing from Israel to other countries. Bezeq International also provides domestic telephony services by means of Voice over Broadband, or VoB, access.

Internet services

In the Internet services sector, Bezeq International provides Internet access services for private and business customers, including terminal equipment and support, with an emphasis on broadband Internet based on ADSL or cable infrastructures; hosting services – website and server hosting and co-location services in a designated data centers, or IDC, installations for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' Internet and LAN connections using the required terminal equipment or software, including monitoring; data services with international data communication IP solutions for business customers, including global deployment if necessary; and wireless (WIFI) access – fast wireless access solutions for private and business customers, including in various public locations (hotspots).

International data service

Bezeq International supplies international data communication solutions for business customers, including customized global deployment. The customer is able to choose from a range of the most advanced data communication methods through the optic cables deployed from Israel to Europe including Bezeq International's own Jonah Cable system and networks of other leading global telecom providers, such as BT, which make available to its customers their sophisticated global network services.

PBX services

Bezeq International markets and provides maintenance and technical support services for advanced PBX systems of a wide range of manufacturers. Bezeq International also provides managed telephony exchange services for enterprises and business compounds.

Business customer services

As part of its comprehensive business ICT (Information Communication Technology) solutions, Bezeq International provides extensive communications services, including: international data communication services, server and website hosting services, ICT systems' technical maintenance and support services, networking and system services, outsourcing and out-tasking services, security and risk management solutions and IP based managed services as well as the most advanced innovative cloud computing services.

In January 2009, Bezeq International inaugurated a new IDC, in addition to Bezeq's existing IDC, which hosts thousands of servers. In September 2011, it inaugurated the second part of the IDC which will enable it to provide hosting services for many additional customers. The establishment of the IDC is part of Bezeq International's strategy to become well established in the business sector, especially among small and mid-sized businesses which now prefer to use outsourcing for their IT requirements and are preparing to be in the forefront of the cloud computing sector. The new IDC established by Bezeq International is a "green" facility based on energy saving infrastructures. The IDC takes advantage of Bezeq International being a leading Internet service provider in Israel by being directly connected to its Internet backbone. In this way, customers can benefit from maximum flexibility in managing their bandwidths and from a wide range of sophisticated services such as server hosting and management, virtual servers and a range of managed services – backup, information security, cyber attack prevention, monitoring, statistics construction, overseas Israel traffic distribution and FTP file transmission services.

In December 2011, Bezeq International began to operate another data center in Jaffa, which had previously been operated by Bezeq. Bezeq International will use this state-of-the art, protected data center to offer its customers a broader range of communications, computing, co-location and hosting services.

Downstream infrastructure and maintenance of the Jonah submarine cable

On November 1, 2010, pursuant to the approval of the boards of directors of Bezeq International and Bezeq, Bezeq International entered into a turnkey agreement with Alcatel-Lucent Submarine Networks for the laying of a submarine optic communication cable, known as the Jonah Cable, between Israel and Italy. In 2011, Bezeq International purchased indefeasible rights of use in a terrestrial infrastructure which links its point of presence in Italy to sites in Western Europe. During December 2011, Alcatel-Lucent Submarine Networks successfully completed the installation of the Jonah Cable and commercial service using that cable was initiated. At that time, Bezeq International entered into agreement with the MECMA consortium for maintenance of the cable.

In January 2011, Tamares Ltd. announced that it completed laying a submarine cable between Israel and Cyprus and the purchase of continuing capacity to Western Europe. On November 3, 2011, the Ministry of Communications published a hearing concerning regulation of the submarine cable sector. The decision of the Ministry of Communications on this matter could affect the activities of Bezeq International in this market.

Competition

In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. By 2004, five other international carriers had entered the market, some of which subsequently merged. At present six international carriers operate in the international telephony market. During the fourth quarter of 2008, Partner entered the market of Internet access and IP-based content and telephony operations and began marketing its products to the general public on January 1, 2009. This meant that Partner became a competitor in the markets in which Bezeq International operates.

In March 2011, Partner completed its acquisition of 012 Smile. At present, licenses for providing Internet services have been granted to approximately 70 companies, including most of the previously mentioned international operator licensees. In December 2010, Hot-Net obtained a special license to provide ISP services and it started providing such services to retail customers on February 2012.

In the international call market, the use of VoIP technology enables transfer of international calls over the Internet as well as for TDM network users, through the use of software products and services of communication providers abroad. The attractive cost of using these services has led to a steady growth in the number of users and as a result, a decline in the international telephony revenues of Bezeq International.

The main characteristic of market competition in 2011 was the merger of communication groups and their offer of comprehensive services and products. The effect of competition has been exacerbated by the trend of tariff erosion.

International telephony services

The international long distance market in Israel is highly competitive. At the end of 2011 there were six competitors in the market: 014 Bezeq International, 013 Netvision, 012 Smile, 018 Xfone, HILAT – Israel Telecommunications Company Ltd., and Telzar International Communication Services Ltd. Bezeq International estimates that its market share in outgoing international calls from customers is approximately 30% compared with a market share of approximately 30.7% at the end of 2010. Bezeq International's assessment of its share of the outgoing customer calls segment at the end of 2011, as well as its estimate that 50% of Israeli households make overseas calls at least once a month, are based on market surveys that were conducted by an outside survey center.

The international call market in Israel has in recent years been characterized by a decline in call volume and in 2010 and 2011 the volume of call minutes (incoming and outgoing) declined by an average of 5.9% and 4.4%, compared to the prior years.

Internet access services

There are a number of competitors in this market, including Bezeq International, 013 NetVision, which merged with Cellcom, 012 Smile (Partner announced that it will merge its operation in this sector with 012 Smile) and two minor niche players whose market share is not material. In December 2010, an ISP license was granted to HOT-Net, which began to supply Internet access services to private subscribers on February 15, 2012.

While there has been growth in the Internet access segment in recent years in terms of the number of customers, the rate of growth is slowing as a result of the high Internet penetration rate in Israel. Approximately 73% of all households in Israel are connected to the Internet, which is a high penetration rate in comparison with the rest of the world. There are currently two principal infrastructure alternatives for customers in the market, Bezeq's ADSL and the HOT cable infrastructure. HOT frequently cooperates with Bezeq International’s direct ISP competitors and provides ISP services through its subsidiary, HOT-Net.

Bezeq International believes that its market share in the Internet services sector is 37.5% compared with a market share of 35.9% at the end of 2010. Bezeq International's estimate of its market share in the Internet access sector is based on a calculation of the ratio between the number of subscribers it has, and the total number of ISP subscribers (based on public data regarding internet infrastructure services provided by Bezeq and HOT).

During the fourth quarter of 2008, Partner entered the Internet access and IP-based content and telephony operations markets and began marketing its products to the general public on January 1, 2009. On March 3, 2011, Partner announced the completion the acquisition of 012 Smile, which is also an ISP. In December 2010 Hot-Net obtained a special license to provide ISP services and February 15, 2012, it began to supply Internet access services to private subscribers.

In August 2010, Bezeq began selling joint service packages that include Bezeq International's Internet access services.

Communication solutions for the business sector

With the aim of increasing revenues from business customers, Bezeq International continues to supply ICT services to businesses, providing comprehensive solutions in such areas as systems, networking, IT, hosting, telephony, data transmission, Internet access and wireless networks.

Bezeq International is facing new competitors in this sector from companies such as Binat, Taldor, and IBM. In 2011 Bezeq International continued to establish its position in the ICT market and to gain recognition and accreditation from leading providers in the market.

PBX Services

The traditional field of PBX (telephone exchanges) is characterized by a large number of competitors and by fierce competition which has given rise to an erosion of service prices. Bezeq International's most prominent competitors are Tadiran, Eurocom, GlobeCall and Tel-Yad. Data communications and IP telephony (adapting switchboards and terminal equipment to IP technology) is characterized by the entry of new players from the IT world. These companies include Binat, Teldor, Malam Tim and IBM. These companies are substantially different from traditional PBX service companies and are on a higher technological level. New operators are entering the market with the intention of providing customers with total communications solutions such as telephony, transmission, data communications, Internet, and information security.

Marketing

The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International, which are used by Bezeq International to remain in contact with the advertising media (television, Internet, radio and the daily national press), production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies.

Seasonality

Bezeq International's revenues and profitability are affected to a limited effect by seasonality and holidays. There are seasonal fluctuations in the following services:

- Voice services for the business sector – decrease in August and during the Passover / Tabernacle holidays.
- Voice services for the private sector – increase in the summer months and towards the end of the calendar year.
- Internet services and NEP equipment – increased sales usually achieved in the fourth quarter.
- Internet services for the business sector – a decrease in the summer months owing to the closure of educational institutions (customers in this sector are not billed for the Internet services to which they subscribe during the summer vacation).

Governmental Regulation

Bezeq International operates under a general license for providing international voice and data services, which is valid until 2022. The provisions of the license regulate the method for determining tariffs charged by Bezeq International for its services, their updating and collecting the payments for these services. Bezeq International also operates under a general license for providing domestic telephony services, a special license for providing Internet services and a special license for providing PBX services.

Under the Communications Law, implementation of telecommunications operations and provision of telecommunications services, including international telecommunications services and Internet access services, require a license from the Minister of Communications. The Minister is authorized to amend the terms of the license, add to them or detract from them, while taking into consideration the government's telecommunications policy, interests of the public, compatibility of the licensee with the provision of services, contribution of the license to competition in the telecommunications industry, and the level of service. The law authorizes the Director General of the Ministry of Communications to impose financial sanctions for violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms. A recently adopted amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe telecommunications services that do not require a license.

Licenses

International carrier license. In providing international telephony and data services, Bezeq International is operating in accordance with its international carrier license which is valid until 2022. The provisions of the license, among other things, prescribes the manner of setting its tariffs for its services, updates and payment collection.

Special Carrier License. On February 8, 2009, the Minister of Communication granted an exclusive general license for the provisions of domestic telecommunications services to B I P Telecom Solutions (LP), a subsidiary of Bezeq International, which allows it to provide domestic telephony services via broadband Internet access, or VoB, until 2029. On August 2, 2009, Bezeq International started providing these services to private customers and on December 30, 2009 this license was amended to permit Bezeq International to provide this service to business customers.

Special license for the provision of Internet access services. On August 10, 2009, Bezeq International received a special license to provide Internet access services (ISP). The receipt of this license puts Bezeq International on an equal footing level with that of all the other ISPs who operate under a similar license. The license is valid until August 29, 2014.

NEP license. On December 31, 2006 the Ministry of Communications confirmed the transfer of the NEP license from BezeqCall, a subsidiary which had engaged in the provision of NEP services, to Bezeq International, following their merger. Since the merger, Bezeq International has provided NEP services under this license. On April 30, 2010, its NEP license was extended until April 30, 2015.

Pursuant to its licenses and the royalty regulations, Bezeq International pays royalties to the State of Israel based on most of its revenues from the provision of international call and domestic telephony services, net of permitted expenses and excluding revenues from certain customers excluded by these regulations.

In 2010 and 2011, Bezeq International paid royalties totaling NIS 2.3 million and NIS 3.4 million, respectively.

Regulatory changes in Bezeq International’s markets

On January 31, 2010, the Ministry of Communications decided to adopt the Gronau Commission’s decision and impose on international calls made from Israel on a cellular network the arrangement applicable to overseas calls made from a fixed line, whereby a consumer dialing abroad from a cellular network is billed only by the international operator which pays the cellular operator for transferring the call, in accordance with the tariff set in the interconnect regulations. The decision further stipulated that the international operator may not increase the price of making an international call to a subscriber dialing from a cellular network over and above the price of a call to the same destination from a fixed-line network, plus the difference between the interconnect charge to a cellular network and the interconnect charge to a fixed-line network. The amendment took effect on August 1, 2010.

On November 1, 2011, the interconnect charges for the cellular operators were reduced, and on January 1, 2012 they were further reduced.

On December 1, 2011, the Ministry of Communications permitted the provision of VoB service to a (general or special) Domestic Carrier's subscriber who is outside Israel by means of an Israeli phone number. Cellular companies will only be permitted to offer this service when their subscribers are abroad. According to a resolution passed by the Ministry, the licenses will be amended accordingly in the near future. This decision may have a positive effect on the business of Bezeq International.

On February 28, 2011, an amendment to the international carrier regulations was published, canceling the limitation concerning "considerable influence" in an international carrier by a cellular operator. Instead of that limitation, the regulations now state that by the earlier of the date on which a virtual cellular operator (MVNO) starts operation or by the end of 2012, the holding of considerable influence by a cellular operator in an international carrier will be subject to structural separation limitations, including separation of the management and assets of the companies, limitations on hiring shared employees, transfer of commercial information between the companies, and a ban on discrimination in favor of the cellular operator affiliated with the international operator over other license-holders. According to an announcement made by Partner on December 21, 2011, 012 Smile's operations will no longer be managed separately from those of Partner.

Bezeq International believes that the entry of cellular operators into the international call market, particularly if they exploit their power as cellular operators in order to strengthen their standing in the international call market, is likely to have a materially adverse effect on its market share.

Consumer Protection Law amendment on billing dates in standing orders

On July 20, 2011, the Consumer Protection Law was amended regarding billing practices. The amended law stipulates that effective January 1, 2012, a business that charges a consumer in installments by a standing order, must offer the consumer a choice of dates for the monthly charge. The business must decide on at least 4 payment dates, provided that there are least six days between one date and the next (more than 4 possible dates may also be offered). Customers who do not choose a billing date will be billed on the 10th of the month (the default date). Supplementary payment may not be charged for implementing this provision (including interest, linkage differences or a penalty).

Hearing on Internet license consumer issues

On December 7, 2011, the Ministry of Communications published a hearing for licensees who provide ISP services, proposing changes in the regulations relating to consumers, including, the form and content of subscriber agreements and bills, provisions for refunds for overcharges or services that were not requested, conditions for discontinuing services, provisions concerning the option to contact an ombudsman, the possibility of changing plans and tariffs, the collection of debts from subscribers, the treatment of subscriber complaints and provisions concerning the obligation to publish information about plans and tariffs. Bezeq International submitted its comments to the Ministry and is making the necessary preparations.

Amendment to the Communications Law on the filtering of offensive content

The amended Communications Law regarding the filtering of offensive Internet content took effect in July 2011. The amended law stipulates that an ISP must inform its subscribers about offensive websites and offensive Internet content and the availability of possible protection against them, and must provide free filtering software. Bezeq International is operating in accordance with the provisions of the amendment.

Amendments to consumer legislation in the Knesset

Several consumer bills have been submitted to the Knesset Economic Affairs Committee that are due to be discussed during the coming spring session. The bills include the following topics: responding to customers within a specified time; the obligation to allow customers to listen to recordings of sales conversations; and offering financial compensation to customers who have been overcharged.

Equipment and Suppliers

Equipment

In 2004, Bezeq International signed an agreement with Veraz, to purchase SoftSwitch switches, which, during 2005, replaced the Alcatel S-12 voice switches (at this stage, these switches are still being used as a non-substantial component in Bezeq International's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an intelligent network, which was also replaced in 2005 as part of the upgrade of its voice setup. Bezeq International's technological infrastructures, which support voice, data and Internet setups, are deployed in five sites to provide services with high survivability.

Suppliers

Bezeq International has cooperation agreements with approximately 180 foreign operators for 240 destinations worldwide.

Bezeq International purchases most of its required capacity for its services from Bezeq. Until recently, Bezeq International purchased most of its required international capacity from Mediterranean Nautilus Limited, or Med Nautilus, which supplies international communications infrastructure through a submarine cable running from Israel to Europe. Since Bezeq International began to use the Jonah Cable, it also uses other international infrastructures.

Under its agreement with Med Nautilus, Bezeq International purchased indefeasible rights of use to an unparticular non-specific part of the communication capacity of the undersea cable system operated by Med Nautilus between Israel and Europe for a period of up to 15 years from the date on which it started using this capacity (with an option to extend the period of use). The periods of use are at least until 2017 – 2027, depending on the date of the start of use of the capacity. Bezeq International paid for these rights of use a non-recurring payment around the date on which it started using the capacity. In addition, in October 2011, Bezeq International entered into an agreement with Med Nautilus to expand and change the existing user rights in the international optic network that it operates, which will be used as a backup for Bezeq International's Jonah Cable between Israel and Italy. Bezeq International is not restricted in the use it makes of the capacity and it may sell its rights, in whole or in part, to third parties. Bezeq International has the option to cease using the capacity, in whole or in part, at any time.

On January 18, 2010, Bezeq International signed an exclusive partnership agreement with British Telecom for the provision of global communications services to Israeli and multi-national companies operating in Israel. As part of the strategic agreement, Bezeq International will operate as the exclusive partner of the BT Alliance in Israel and will market IT services and products from British Telecom's global range of services.

Property

Bezeq International leases the two main facilities from which it operates from an unrelated party for an aggregate annual rent of NIS 8.5 million (approximately $2.4 million). The lease agreements' term end in 2014 and 2015.

Employees

Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives. These groups include sales employees, telephone sales representatives, and telephone service and support representatives. Employees have arrangements for pension and health insurance that are fully subsidized by Bezeq.

The following table shows the number of persons employed by Bezeq International, including outsourced employees, at December 31, 2010 and 2011:

	Number of employees	
	2010	2011
Head office employees	968	1,209
Sales and service representatives	1,144	1,053
Total	2,112	2,262

Other Investments

Bezeq International established B-Zone, a general partnership, with 2Plus Wireless Solutions Ltd. in 2006. B-Zone was established to set up, support and manage wireless networks in public areas, enabling connection to the Internet and collecting payment from the end-user.

Bezeq International and DSNR Communications Ltd. established a company under which Bezecom Ltd. was established in January 2007. The purpose of Bezecom is to provide international telephony services to end-users worldwide.

Bezeq International does not have any significant investment activity in investees, partnerships and ventures that are not subsidiaries, nor investments in other operations. B-Zone and Bezecom are joint ventures that are insignificant to the operations of Bezeq International.

DBS

DBS, known also by its trade name YES, provides multi-channel satellite broadcast services to subscribers. DBS was founded on December 2, 1998, and has been providing this service since July 2000. This service enables the provision of multi-channel encrypted digital television broadcasts and value-added services to subscribers who receive the broadcast at home via a small antenna dish from which broadcasts are transmitted to a domestic decoder in the subscriber's home and connected to the television set. Most of DBS's income derives from subscription fees and additional payments made by viewers. DBS is the only company in Israel currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

The field of television broadcasting in Israel is highly regulated. Broadcasting is carried out pursuant to various broadcast licenses and is subject to the ongoing supervision of the Ministry of Communications and the Council for Cable TV and Satellite Broadcasting, or the Council. Multi-channel television broadcasts have been provided in Israel since the early 1990s. Since December 2006, the cable companies operating in Israel merged into a single merged cable company, HOT, which supplies cable television services to all of the subscribers of the merged cable companies pursuant to a long-term broadcast license. HOT holds all of the rights in a limited partnership which owns the cable network infrastructure, including the terminal equipment, end user equipment and broadcasting centers.

Control of DBS

On August 20, 2009, the Supreme Court handed down a verdict in the appeals filed by the Antitrust Authority and Eurocom D.B.S. Ltd., or Eurocom DBS, a principal shareholder in DBS which is controlled by our parent company, the Eurocom Group, against the verdict of the Antitrust Tribunal dated February 3, 2009, approving the merger of Bezeq with DBS Satellite Services (1998) Ltd, or DBS, subject to certain conditions. The Supreme Court accepted the Antitrust Commissioner's objection to the merger and decided not to approve the merger. In view of the Supreme Court's ruling, Bezeq believes that it will not be able to control DBS and accordingly, as of August 21, 2009, it ceased to consolidate DBS's financial statements into its consolidated financial statements, and the investment in DBS's shares is presented as of that date according to the equity method.

In April 2010, in the context of the Ministry of Communications' approval of our acquisition of control in Bezeq, the Ministry approved DBS's request, as required by its license, for the transfer of Eurocom DBS's holdings in DBS to a trustee, subject to the following conditions:

- No change, direct or indirect, in the trustee's holdings of the means of control in DBS may be made without the prior written approval of the Minister of Communications, after he has consulted with the Council.

- The trustee will not act in accordance with guidance received from any party which has a direct or indirect interest in an area of regulation by the Ministry of Communications, unless it has received the approval from the Ministry of Communications.

- Any transaction between DBS and the Eurocom Group concerning satellite terminal equipment will be considered an extraordinary transaction as defined in the Israeli Companies Law and therefore, such transactions will be subject to the approval proceedings applicable to DBS and Bezeq pursuant the Israeli Companies Law.

- All discussions by the board of directors of DBS concerning transactions as described in the above paragraph must be documented in detail, and comprehensive minutes signed by the chairman of the meeting must be submitted to the Director General of the Ministry of Communications for his review.

The approval of the Antitrust Commissioner for our acquisition of control in Bezeq was made contingent, among other things, on the sale of Eurocom DBS's holdings in DBS within a defined period of time. To the best of our company's knowledge, the Antitrust Commissioner is currently discussing the conditions mentioned regarding Eurocom Group's holdings in DBS.

Products and Services

DBS's broadcasts approximately 150 different video channels, of which 14 are pay-per-view (PPV) channels and 19 are high definition, or HD, channels, 20 radio channels, 30 music channels and interactive services. The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or as single and PPV channels.

DBS markets personal video recorder, or PVR, decoders which interface with DBS's electronic broadcast schedule and enable receipt of special services, including ordering recordings in advance, recording series and pausing live broadcasts. The PVR decoders also enable viewing of the content which is transferred from time to time to the decoder's memory stored in the decoder's memory which is updated from time to time by DBS (push video).

DBS also provides its subscribers with HD broadcasts which can be received through special decoders. These broadcasts which at present are provided for a limited number of channels, allow superior quality viewing. DBS also markets HDPVR decoders.

In 2011, DBS achieved a significant increase in the number of its subscribers using PVR decoders. DBS believes that an increase in the number of subscribers using PVR decoders contributes to an increase in its revenues from these subscribers and to their retention as subscribers, but it will require a material financial investment.

The following table provides summary condensed financial information concerning DBS's multi-channel broadcast services for the two years ended December 31, 2011:

	2010	2011
Revenues (NIS millions)	1,583	1,619
Operating profit (NIS millions)	178	295
Depreciation and amortization (NIS millions)	285	276
Operating profit before depreciation (NIS millions)	463	571
Net profit (loss) (NIS millions)	(314)	(230)
Cash flow from current operations (NIS millions)	492	513
Payments for investments in property, plant and equipment and intangible assets (NIS millions)	277	264
Free cash flow (NIS millions) (1)	215	249
Number of subscribers (2) (at the end of the period, in thousands)	578	586
Average monthly revenues per subscriber (ARPU) (3) (NIS)	230	232
Churn rate (4)	13.0%	11.9%

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

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

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

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

DBS provides its subscribers with VOD services via the Internet. This service has limitations with regard to the types of decoders enabling service reception and with regard to availability of services owing to restrictions on the Internet infrastructure and bandwidth installed in customer homes. In 2011, the number of DBS subscribers connected to VOD services increased significantly. During 2011, DBS began to market advanced HD decoders which also enable the supply of VOD services and also launched a service enabling the viewing of certain computer content on TV screens, through the use of some types of advanced decoders.

DBS has a content site on the Internet which it operates together with Walla! on which a range content can be viewed, some of it for payment. In December 2011, Zira Ltd., whose purpose is to prevent the infringement of copyrights on video content on the Internet, commenced operations. DBS is one of the founders of Zira, together with other corporations that operate in the television sector.

The increase in the bandwidths of communication infrastructures in Israel, alongside technological improvements has led to the development of transmission of video content on communication infrastructures which in turn has led to an increase in the number and range of video content accessible to the public (whether with or without authorization from the holders of title to the content) through the various communication infrastructures, and to a change in the format in which downloaded content is used for streaming. Viewing the content is by means of various types of terminal equipment, including PCs and television tablet, and mobile phone.. The development of this trend enables the supply of various forms of video content without the need to set up a designated infrastructure system, and it could have a materially adverse effect on the broadcasting sector, which is currently based on designated infrastructures. This effect could be aggravated if the supply of content continues to be unregulated.

DBS regards the following factors as critical to the success of its operations:

- Quality, differentiation, innovation and originality in the content, variety, branding and packaging of its broadcasts;
- Provision of television services while using advanced technologies such as personal television services, and in particular, VOD services and PVR and HDPVR devices;
- Offers of service packages of communications services including television services and other services such as telephony services and Internet services;
- High level of customer service; and
- Brand strength and identification of DBS with quality, innovation and industry-leading content and services.

DBS has significant expenses involved in the use of space segments which are necessary to provide DBS's broadcasts. There is also a restriction on its ability to expand supply of its broadcasts which depends on availability of additional space segments or an improvement in compression capability which entails a financial investment.

Broadcasting rights

DBS has the broadcasting rights to two types of video content:

- Content purchased from third parties that own the broadcasting rights; and
- Content which DBS invests in producing (wholly or partially) and has the right to include the content in its broadcasts. In most instances, DBS is also entitled to authorize the use the content to third parties and share the revenues stemming from additional use of the content.

The broadcast and distribution of content by DBS on various media involves the payment of royalties to the owners of copyrights of musical works, voice records, scripts and content direction, including under the Copyright Law, 2007 and the Performers and Broadcasters Rights Law, 1984. Payment of royalties is made through a number of organizations that operate in Israel that collect the royalties for the owners of the intellectual property rights. DBS has blanket licenses with these organizations. Payments by DBS under these licenses are, at times, based on a fixed payment and at other times on various pricing methods, and with respect to some of the organizations, for the transfer of content over certain media, DBS may be required to pay additional amounts that are not expected to be significant.

DBS and one of the organizations, the Association of Composers, Authors and Publishers of Music in Israel, or ACUM, previously had agreements, according to which the royalties paid to ACUM beginning in 2003 were to be advances on account of the royalties, at a rate based on what HOT pays ACUM, and that these amounts would be paid until a different agreement is reached with ACUM. To the best of DBS's knowledge, based in part on immediate reports published by HOT, HOT and ACUM signed a settlement agreement for the period 2003-2010, and provided for payments of annual royalties during the period 2011 through 2016. DBS and ACUM are currently attempting to negotiate an agreement that will regulate the level of royalties that DBS owes ACUM for the period 2003 through 2010, as well as the payment of royalties for 2011 through 2016.

Additionally, DBS enters into license agreements to broadcast local and foreign channels in consideration of a fixed annual payment or a payment dependent upon the number of subscribers for the relevant channel.

Given the many content providers from which DBS purchases broadcasting rights, DBS is not materially dependent on any single content provider. However, with respect to broadcasts of Israeli sports, it is dependent on two content providers for broadcasting rights to local sports channels.

Customers

The majority of DBS's subscribers are private customers. DBS's subscriber agreements regulate the rights and obligations of subscribers in their relations with DBS. Pursuant to the provisions of its broadcasting license, the text of the subscriber agreement requires approval from the Council and from the Standard Contracts Tribunal. The subscriber agreement has been approved by the Council and also by the Standard Contracts Tribunal. At present, the validity of the approval granted by the Standard Contracts Tribunal has expired. The Council has approved a number of amendments to the subscriber agreement and DBS is working to obtain its approval of the other amendments, after which the amended subscriber agreement will be resubmitted for approval to the Standard Contracts Tribunal.

DBS’s supply of broadcasts and services and their prices appear in its price list. Most subscribers sign up for offers where DBS's services, including various components of the content bundles, accompanying services and terminal equipment and their installation, are provided at prices lower than the prices published in the price list.

Marketing and Distribution

Marketing of DBS services is by way of publication in the various media. DBS’s sales operations are carried out via three main distribution channels:

- Sales persons employed by DBS who recruit subscribers;
- Call centers operated by DBS employees, that receive telephone enquiries from customers wishing to obtain DBS services, as well as telemarketing campaigns to potential subscribers; and
- External resellers. In October 2011, an agreement was terminated between DBS and one of the external resellers who recruited approximately fifty percent of the subscribers recruited by all external resellers and a significant proportion of their work focused on the recruitment of a specific target population.

Competition

Approximately 70% of all homes in Israel subscribe for multi-channel television services. DBS’s principal direct competitor is HOT. DBS also regards the DTT setup as competition for its services.

To the best of DBS's knowledge, in recent years there has been a decrease in the total number of DBS and HOT subscribers, with a moderate increase in DBS's share of the multi-channel television market. Below is information, which DBS believes to be accurate, relating to subscriber numbers and its market share at December 31, 2009, 2010 and 2011:

2009		2010		2011	
Subscribers	Market share	Subscribers	Market share	Subscribers (1)	Market share
570,000	38%	577,700	39%	586,400	40%

(1) A subscriber is either one household or one small business customer. For business customers with many reception points or a large number of decoders (such as a hotel, kibbutz or gym), the number of subscribers is calculated by dividing the total payment received from the business customer by the average revenue from a small business customer.

To the best of DBS's knowledge, in recent years there has been a decrease in the total number of subscribers of DBS and HOT, with a moderate increase in DBS's share of this market. The strengthening of alternative products may result in a decline in the above-mentioned penetration rate. Consequently, an increase in the number of subscribers may be accomplished mainly by recruiting subscribers from the competition and recruiting new subscribers following the natural growth in the number of households. This means that the broadcasting sector is characterized by fierce competition between HOT and DBS, which requires an investment of substantial resources to retain existing subscribers and recruit new ones. HOT has a much greater degree of accessibility to customers of its analog system who wish to receive digital television services. The analog broadcast method allows subscribers to receive broadcasts at a relatively lower cost.

DBS transmits its broadcasts using a digital broadcasting method only, whereas HOT broadcasts to most of its subscribers using a digital broadcasting method, while for the remainder it uses an analog broadcasting method which allows for lower-quality viewing, does not enable display of an electronic program guide and requires the purchase of a uniform channel package without the option of choosing broadcasting segments. To the best of DBS's knowledge, HOT is working to reduce the number of its subscribers connected to the analog system.

Competition in the broadcasting arena focuses on content, packages and channels, on service and on offering additional services such as VOD services, PVR decoders, and HD broadcasts. In recent years there has been a discernible trend toward demand and supply of personal television services which allow the customer to choose which content to view and when to view it (in contrast to viewing linear channels where the content broadcasting sequence is determined by the broadcasting entity). This trend is supported by the expansion of PVR services, VOD services and other services.

DBS believes that competition may increase due to the additional communication services offered by HOT as part of its “service bundle.” Towards the end of 2011, HOT acquired Mirs, a cellular carrier, and cooperation between these two companies may be possible.

Digital Terrestrial Television

Since August 2009, the Second Television and Radio Authority, or the Second Authority, has been operating a DTT broadcasting system which freely broadcasts the television channels of the broadcasting authority (Channel 1 and Channel 33), commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) to the nation. This setup constitutes a partial alternative product to the broadcasts of DBS and DBS believes that any material increase in the number of users of this alternative system may have an adverse effect on its revenues.

In April 2012, the Knesset passed the Broadcasting by Means of Digital Broadcast Stations Law, according to which, among other things, the DTT system will be expanded by December 31, 2013. This law provides, among other things, that the following will be added to the DTT system: (i) a radio channel containing national and regional radio channels, (ii) a channel for Israeli and Mediterranean music (to which an Arabic channel is due to be added when it is set up), and (iii) should they make an application, the Educational TV channel, another Israel Broadcasting Authority channel to be broadcast using HD technology and a designated channel (today there are two designated channels). However, the broadcast of a designated channel in addition to five designated channels is subject to free capacity available for this purpose; the inclusion of one of the aforementioned channels will be made in consideration of payment of distribution fees. After consulting with the Second Authority Board, and subject to the approval of the Knesset Economic Committee, the Minister of Communications may order the gradual inclusion of up to 3 more "special subject channels" to be selected in a tender process, so that each special subject channel will begin broadcasting one year after its predecessor commences broadcasts and for payment of distribution fees. Commencing January 1, 2014, the DTT system and its operation will be transferred from the Second Authority for TV and Radio to a public body, statutory corporation or government company that does not broadcast radio or television broadcasts, to be appointed by the Minister of Communications and the Minister of Finance, with government approval and the approval of the Knesset Economic Committee.

DBS believes that an increase in the number or range of channels distributed through the DTT distribution system will increase the number of alternatives to DBS’s services and may have a detrimental effect on DBS's revenues.

In February 2011, an amendment was enacted to the Second Authority Law, most of which deals with a change in the method of regulating commercial broadcasts, while transferring from the system of granting franchises to a system of granting licenses for commercial television broadcasts to anyone complying with the threshold terms without a tender proceeding, or a Commercial Licensee, and includes, among others, the following arrangements: the date of transfer between the systems is scheduled to be January 1, 2013; each Commercial Licensee may be included in the DTT broadcasting setup; the Minister of Communications, after consultation with the Council and the Second Authority, may choose five sequential channels designated for the transfer of broadcasts of a Commercial Licensee by DBS and HOT; a mechanism whereby the moneys received from the Commercial Licensees for the use of the five sequential channels will be used to produce original productions which will be broadcast by DBS and HOT and in the broadcasts of franchisees and/or Commercial Licensees, in accordance with a distribution to be determined. After holding a consultation proceeding, the Minister of Communications announced on February 28, 2011 that the channels designated for the broadcasts of Commercial Licensees by DBS and HOT will be Channels 12 to 16. DBS believes that an increase or variation in the number of channels to be distributed through this setup will likely increase the capability of the setup to compete with DBS's services and this may adversely affect its revenues.

Governmental Regulation

The television broadcasting industry in Israel is highly regulated. Broadcasting is carried out pursuant to various broadcast licenses and is subject to the ongoing supervision of the Ministry of Communications and the Council for Cable TV and Satellite Broadcasting. DBS’s operations are regulated by and subject to an extensive system of laws that apply to the area of broadcasting, including primary legislation (and specifically the Communications Law and subsequent regulations), secondary legislation (including the Communications Rules), as well as administrative directives and Council decisions). All these materially affect DBS and its operations. In addition, legislation and secondary legislation in the field of consumer protection have a material impact on DBS.

The Minister and the Council have parallel authority to amend DBS’s broadcast license. The Minister is authorized to cancel or postpone the broadcast license for causes set out in the Communications Law and the broadcast license. The Communications Law and broadcast license stipulate restrictions on the transfer, attachment and encumbrance of the broadcast license and any of the assets of the broadcast license. The broadcast license requires receipt of the approval of the Minister for specific changes in the holding of the means of control in DBS and imposes a reporting requirement regarding the holders of the means of control; hurting competition in terms of provision of broadcasts and services is prohibited, including terminal equipment and other telecommunications services unless approved in advance and in writing by the Council; the obligation to file reports to the Ministry of Communications was defined as well as conditions regarding the regulation of the activity of the licenses; an obligation was agreed upon to provide bank guarantees of NIS 39 million ($10.1 million) to the Ministry of Communications to guarantee DBS's undertakings under the license.

Statutory restrictions and special constraints

The Communications Law requires that a broadcast license be obtained in order to transmit satellite television broadcasts to the public. In January 1999, DBS received a broadcast license which is valid until January 2017 and is renewable for additional six years periods, subject to the conditions of the license.

In addition to the licensing required for broadcast operations, operations in this area and in other areas of communication are subject to licensing, supervision and the policy decisions of the Ministry of Communications with regard to aspects defined in the law and the communications licenses (which relate mainly to matters regarding competition, consumers, and technical and engineering aspects). As a result of the convergence and overlap between broadcasting and other areas of communications, and the operations of HOT and related telephony and Internet entities, broadcasting is materially influenced by the policy and supervision of the Ministry of Communications in various additional areas.

The broadcast operations of DBS and HOT are under the ongoing supervision of the Council. The Council sets policies, adopts rules and has supervisory authority regarding the content of broadcasts, the duty regarding original Israeli productions, broadcasting ethics, consumer protection and other matters in the area of broadcast policy. The Council is also authorized to amend the broadcast licenses of DBS and HOT. Pursuant to the Communications Rules (Broadcasting Licensee) 1987, or the Communications Rules, various obligations and restrictions apply to DBS, including those relating to broadcast content and the amount and manner of investment in local productions. DBS may own up to 30% of the local channels broadcast by it.

The broadcasting license sets out provisions that relate to the content of DBS's broadcasts, including an obligation to obtain the Council's approval of the channels broadcast by DBS. The Communications Law prohibits the broadcast of advertisements, subject to several exceptions. Additionally, the broadcasting license includes conditions regarding the terms of the services to subscribers and prohibition of discrimination between subscribers as well as an obligation to have the Council and the Standard Contracts Tribunal approve the subscriber agreement.

In 2009, a government resolution was passed amending the Communications Law so that it defines, among other things, legislative arrangements that will obligate DBS and HOT to allow all subscribers to connect to a package consisting of Channel 1, Channel 33, Channel 2, Channel 10 and the Knesset Channel, or the Basic Package, subject to conditions prescribed in the resolution. According to this government decision, DBS and HOT will be entitled to broadcast advertisements beginning in 2012, subject to rules to be prescribed by the Council. To the best of DBS's knowledge, the issue of the Basic Package is still being considered by the government.

In February 2012, The Israeli Law, Information and Technology Authority, or ILITA, informed DBS, after negotiations conducted by the parties, that commencing on March 14, 2012, DBS is required to discontinue any use of information about subscribers who have terminated their agreements with DBS effective February 29, 2012 for marketing purposes, unless the subscribers knowingly give their specific and separate consent to this effect. Any use that deviates from the requirement will be deemed to have breached the provisions of the Protection of Privacy Law, 1981. DBS is permitted to make a one-time use of information about subscribers who had disconnected from DBS's services prior to February 29, 2012 until the end of May 2012. DBS believes that implementation of ILITA's position may affect DBS's revenues.

In accordance with the requirements of the broadcasting license and the decisions of the Council, DBS was required to invest in local productions in 2010 and 2011 an amount equal to no less than 8% of its revenues from subscription charges and was required to invest specified amounts in different types of local productions. In this context, DBS was required to invest at least 50% of all its investments in local productions that are broadcast on channels that it does not own and DBS was required to ensure that it had no interest in the productions broadcast on such channels. In December 2011, the Council resolved, among other things, to charge DBS NIS 40 million to make up shortfalls in local productions on channels that are owned by outside producers for the years 2007 through 2011, to be paid over the period 2012 through 2016. In view of this decision, DBS will have to make changes in the mix of local productions and the methodology used in ordering them. DBS is also completing investment shortfalls determined by the Council in certain genres.

In October 2011, the Council informed DBS that commencing in 2012, its revenues from subscription fees, which are the basis for calculating the obligation for local productions, would be considered as including any payments paid by its subscribers to receive their broadcasts and acceptance of their services, including revenues from terminal equipment and the installation of such equipment. Consequently, DBS will have to increase its total annual investment in local productions.

Under the Royalties Regulations (Satellite Broadcasts), DBS must pay royalties on its revenues from the provision of broadcast services. For 2011, DBS paid approximately NIS 17.4 million in royalties (the percentage of royalties that year was 1.75% of the relevant revenues).

Terminal equipment

In March 2011, the Ministry of National Infrastructures published Draft Energy Sources (Maximum electrical output in active stand-by mode of a digital channel converter for TV broadcast reception) Regulations, 2011, to regulate the maximum electrical output when digital converters are on active standby mode. As far as DBS is aware, this draft has not yet been discussed by the Knesset Economic Affairs Committee, and at the date of this annual report the Ministry of National Infrastructures is making changes in the draft before presenting it for discussion. Preliminary investigations conducted by DBS show that should the original version of the draft regulations become binding legislation, it may adversely affect DBS's ability to continue to use some of the decoders currently used by its subscribers and its ability to import the decoders that require a higher level of electricity capacity than the maximum output prescribed in the draft regulations. DBS has asked the Ministry of National Infrastructures to amend the wording of the draft regulations so as to minimize wherever possible these possible adverse effects.

In July 2011, the Council chair informed DBS that he intends to recommend that the Council consider amending DBS's broadcasting license so that the deposit that subscribers are required to make for borrowing an HD or PVR decoder will be limited to the cost of the purchase of the decoder provided to the subscriber. In August 2011, the Council chair also informed DBS that he intends to recommend that the Council amend the subscription agreement so that the amount deposited when borrowing used terminal equipment, is not more than its depreciated cost. DBS has expressed its objections on this subject to the Council chair. DBS is of the opinion that in the event that these recommendations are implemented, its revenues will be materially reduced.

Transmission fees

In accordance with the requirements under the law and license, DBS is required to allow the producers of channels identified in the law to use its infrastructures to transmit broadcasts to its subscribers in exchange for payment, or a transmission fee, to be determined in their agreement with DBS, and in the absence of an agreement, in exchange for a payment to be determined by the Minister of Communications, after consulting with the Council.

In March 2009, the Ministry of Communications announced a hearing on the amount of the transmission fee, noting that the results would serve as the foundation for the decision on the dispute between DBS and the dedicated channels (who have not entered into a transmission agreement) and the amount of the payment to be determined in the hearing will apply from 2007 through the end of 2013. The parties will be able to use the calculation method to calculate the amount of the payment through 2006. The Ministry of Communications noted that its economic opinion, which it attached to the hearing, could serve as the basis for settlement of other disputes that may arise between DBS and other independent channel producers. In November 2010, as part of the hearing, DBS received the economic opinion of the Economic Department at the Ministry of Communications. According to the opinion, the annual usage fees would amount to NIS 2 million for an independent channel producer that is not financed by subscription fees. The decision of the Minister in this regard has not yet been received. In accordance with an amendment to the Communications Law in July 2010, the dedicated channels are exempt from payment of transmission fees to HOT and DBS. In September 2010, DBS filed a claim with the High Court of Justice against the validity and applicability of this amendment.

Wiring in subscribers' homes

The Ministry of Communications has issued administrative directives which regulate situations where a subscriber switches from HOT to DBS and vice versa. The directives determine the obligation to pay a monthly usage fee in respect of the infrastructure (wiring) that is owned by the other multi-channel television provider. In some subscriber homes, DBS is dependent on the use of the internal wiring that belongs to HOT and the use of which is done under the administrative directive. In the past, disputes arose between DBS and HOT regarding implementation of the administrative directives. In July 2010, an agreement was signed between DBS and HOT, under which DBS paid HOT an agreed amount to clear its demands with respect to the use of infrastructure in subscriber homes through the end of 2010, and it was determined that as of 2011, there would no longer be a requirement of either of the parties to pay the other party in respect of the use of the wiring in accordance with that set out in the agreement. In September 2010, DBS and HOT contacted the Ministry of Communications with a request to amend the administrative directives, to cancel the obligation to provide prior notice of the connection to the other licensee prior to performance of the actual connection in the event a subscriber switches between licensees, such that the licensee to which the subscriber connects will submit the notice of disconnection from the subscriber to the licensee from it was disconnected only after performance of the connection to the other licensee. The Ministry of Communications has not yet issued a decision on this matter.

Service bundles

According to its broadcast license, DBS may offer joint service bundles that include services provided by Bezeq and services by DBS, subject to obtaining Ministry of Communications approval (and if no objections are raised within the period specified in the license, such approval will be deemed granted) and subject to conditions, the most important of which are the "unbundling" obligation, and whether a corresponding bundle is marketed by a licensee that is unrelated to Bezeq. The joint service bundle with Bezeq includes infrastructure service for Bezeq's Internet only, does not require Ministry of Communications approval and the unbundling obligation does not apply to it. At the date of this annual report, DBS does not market such joint service bundles.

VOD services

In October 2011, the recommendations of the joint Ministry of Communications and Council task force were submitted to the Minister of Communications. The task force was appointed to review the question of regulating broadcasts on new technologies and platforms, with respect to the method and process of prescribing regulations for semi-TV broadcasts (audio-visual content) over the Internet. The primary recommendation is to shift from regulation based on transmission and recording methods to regulation based on output, so that Internet-TV broadcasts should have the same features as the broadcasts currently offered by the broadcasting entities (the criteria for determining these features were included in the task force recommendations and are subject to regulation by the Council and any other relevant regulating entity). It was also recommended that a follow-up team be established, involving all the relevant entities, including the Ministry of Communications, the Council, the Israel Broadcasting Authority and the Second Authority for Television and Radio, for the purpose of reviewing and adapting the regulations currently applicable to the present realm of broadcasting to the developing realm of broadcasting, in an effort to create a standard, comprehensive set of regulations for both the existing and new realm of broadcasts (including a recommendation on appropriate legislative amendments). The task force noted that it must continue to take into account possible changes in the distribution of revenues between the broadcasting entities and the new entities and the expansion of the range of broadcasting entities that will be subject to the new regulations. The task force also recommended that if the new broadcasting entities continue to replace the regulated broadcasting entities (the task force found that the replacement rate is still low), which will have a negative economic impact on the regulated broadcasting entities even before the recommended regulations are adopted, the regulating entities should work for the adoption of urgent, temporary regulations to include temporary relief for the supervised entities and/or impose obligations tailored to the web-based broadcasting entities. As of the date of this annual report, the Minister of Communications has yet to make a decision regarding these recommendations.

At the date of this annual report, DBS believes that its VOD services are not subject to the regulations that currently apply to multi-channel TV broadcasts and as far as it is aware, this is the position of the Ministry of Communications. Nevertheless, implementation of the recommendations of the joint Ministry of Communications and Council task force may have repercussions for regulating VOD services provided by DBS. It may also affect the development of the transfer of video content over the Internet.

Consumer Protection Laws

On February 13, 2011, the Ministry of Communications distributed a Law Memorandum – Communications (Amendment No. 47) (Limitation on payment and loss of benefit due to cancellation of an agreement) Bill, 2011, in which it is proposed to limit the exit commission that a license-holder can collect from a subscriber who cancels a subscription agreement to 8% of the average monthly bill of the subscriber up to the date of cancellation, multiplied by the number of months remaining to the end of the term of the commitment. License-holders are prohibited from demanding immediate payment of the balance of the subscriber's payments for terminal equipment in the event of cancellation of the agreement. According to the Memorandum, this prohibition will also apply to existing subscribers who request cancellation of their agreements with license-holders after the amendment comes into force.

Suppliers

DBS incurs significant expenses to lease satellite space segments in order to provide its programming to the reception dishes installed in subscriber homes. The space segments under long-term agreements. DBS is dependent on the continuing regular availability of the space segments.

DBS purchases digital decoders for the purpose of receiving and decoding its encrypted broadcasts in customer homes. A present DBS purchases decoders from two suppliers. The main agreement for the purchase of decoders is with Advanced Digital Broadcast S.A., or ADB, and Eurocom Digital Communications Ltd., which is indirectly controlled by Mr. Shaul Elovitch, the holder of indirect control in DBS, or the ADB Agreement. Under the ADB Agreement, DBS purchases decoders from ADB from time to time in accordance with purchase orders which DBS sends to Eurocom. DBS was also awarded a warranty period for the set-top boxes and support services obtained from Eurocom. In 2011, DBS purchased HDPVR decoders from Eurocom for NIS 99 million ($26 million). Replacing ADB will entail a considerable preparation period since it is the primary supplier for this type of decoder. DBS purchases HD Zapper decoders from another supplier under an agreement entered into in August 2011 and in 2011 it purchased NIS 2 million of decoders from that supplier.

DBS is dependent on ADB through Eurocom for the purchase and maintenance of the decoders, including the PVR and HDPVR decoders. While replacing the supplier of the decoders with another supplier will not in itself involve additional material cost, management of DBS believes a replacement would entail a significant preparation period in order to adapt the decoders of the replacement supplier to DBS's broadcasting and encryption system and this would lead to a loss of revenues for DBS. Maintenance of decoders by a different supplier which did not supply the decoders may involve additional costs and difficulties.

DBS purchases services for the operating systems of its broadcast and encryption setup from NDS Ltd., or NDS, as well as hardware for these services. DBS is dependent on the regular supply of these services and products, including integration in connection with the various types of decoders it uses for the operating systems for which NDS provides services.

Under the terms of the agreement with NDS, NDS supplies development, licensing, supply, training, assimilation and maintenance services for encryption, broadcasting and ancillary software and equipment required for the broadcast system. NDS has undertaken to adapt the equipment and services it supplies to the various decoders and systems purchased by DBS and to supply a warranty for its products and also support services. DBS has also entered into agreements with NDS for the purchase of services enabling the provision of PVR, HD and VOD services. DBS makes one-off payments and periodic payments for the services and products of NDS. These payments are based primarily on the number of decoders it uses and the number of its active subscribers. The agreement with NDS expires at the end of December 2013.

Space segment lease agreements

DBS and Spacecom Communications Ltd., or Spacecom, a company controlled by the Eurocom Group has an array of agreements under which DBS uses space segments provided by the Amos 2 and Amos 3 satellites, or the Space Agreement. Pursuant to the Space Agreement, the term of use of the space segments on the satellites is until the earlier of April 2016, or until the end of life of AMOS 2. The consideration for use of the space segments consists of annual usage fees paid in monthly installments, the amount of which depends on the total number of segments supplied by Amos 2 and Amos 3 to DBS, its shareholders and entities affiliated with DBS, as defined in the Space Agreement. DBS was also granted the right of first refusal for additional space segments on AMOS 2 under the terms specified in the agreement. Pursuant to the Space Agreement, DBS must use 13 space segments, and while DBS may temporarily stop using a single segment, each party is entitled to bring about its renewed use (once a year). A mechanism was set up for partial backup on Amos 3 in the event of non-availability of space segments on Amos 2. Additionally, Spacecom undertook to make every reasonable effort to provide backup on Amos 2 in the event of non-availability of both space segments used by DBS on Amos 3. As of the date of this annual report, DBS is using 12 space segments (ten on Amos 2 and two on Amos 3) and in February 2012, Spacecom informed DBS that DBS could resume use of the 13th segment commencing January 1, 2013. The lease fees in 2011 amounted to approximately NIS 87 million.

If the supplied capacity becomes unusable, Spacecom must make every effort to provide alternative capacity, and if Spacecom is unable to do so, it will work to provide such capacity through a satellite belonging to another operator. Should the cost of the alternative capacity exceed that set out in the agreement, Spacecom will be responsible for half of this cost, provided that it does not exceed $50,000 per segment annually. Should work be required to adapt the ground infrastructure in subscriber homes, Spacecom will bear the costs that apply to DBS, up to $2.5 million, with DBS bearing the remaining costs.

DBS is materially dependent on Spacecom, as the exclusive holder of the rights and the sole provider of space segments used by DBS. Spacecom is also responsible for operation of the space segments. In September 2011, Spacecom published an Immediate Report concerning a malfunction in the battery of the Amos 3 satellite, in which the voltage in the battery dropped during an "eclipse period" (a regular, cyclical phenomenon that occurs twice a year, for a period of 42 days each time, during which the satellite and the solar panels that supply it with electrical energy are hidden from the sun during the day), probably due to a fault in one of the battery cells. As a result, Spacecom announced that to reduce the load on the accumulator during the eclipse period, it intended not to operate up to two transponders during this period. Spacecom further noted that in its opinion and the opinion of the satellite manufacturer, this operations plan will facilitate proper function of the satellite, although it commented that there is no certainty that this plan would suffice, and Spacecom may be required to take further operational measures. Spacecom has informed DBS that the failure to operate these transponders is unlikely to affect the service that DBS receives from Spacecom.

Property

DBS' central broadcasting center is located in Kfar Saba, Israel and a secondary broadcasting center is located close to Re'em Junction, Israel from where it transmits its broadcasts. Its broadcasting centers contain reception and transmission equipment and DBS's property, plant and equipment which also include computer and communication systems. The secondary broadcasting center is operated by a third party which makes available to DBS its services for operating and maintaining the secondary broadcasting center in accordance with an agreement which is valid until the end of 2013 (with an extension option available to DBS).

DBS leases a number of real estate assets which serve as its offices, broadcast centers, logistics center and employee recruitment centers. Its principal offices and its principal central broadcast center are located on leased land in Kfar Saba. The lease periods for these sites expire in 2019, while the balance of the lease periods for the remaining properties leased by DBS vary from a few months to approximately nine (9) years (these periods are based on the assumption that DBS will exercise its extension options for these leases).

Employees

The table below provides data with respect to the number of DBS employees at December 31, 2010 and 2011:

Department	Number of Employees		
	2010	2011	
Marketing Department	38	35	
Customer Service (1)	1,462	1,752	
Content Department	74	78	
Engineering Department	101	97	
Finance and Operations Department	118	115	
Human Resources Department	52	48	
Regulation and Legal Management Department	4	3	
Information Systems Department	100	94	
Management and Spokesperson	15	7	
Sales	263	N/A	(1)
Total	2,227	2,229	

(1) At the beginning of 2011, the sales department was spun off from customer service into an independent department.

DBS employees are employed under personal employment agreements, on the basis of a monthly salary or an hourly wage, with some of the employees also entitled to performance-based compensation. The employment agreements are generally for an undefined period, and each party may terminate the agreement by prior notice in accordance with the agreement or the law.

DBS employs personnel in some of its departments on the weekly day of rest and on days of rest prescribed by the State, and it has an appropriate permit for such employment.

012 Smile - Our Legacy Communications Business

Prior to our sale of 012 Smile effective January 1, 2010, we were a leading communication services provider in Israel offering a range of services, including broadband and traditional voice services. Our broadband services included broadband Internet access with a suite of value-added services, specialized data services, local telephony via VoB, primary rate interface services, IP Centrex, server hosting and a WiFi network of hotspots across Israel. Our traditional voice services included outgoing and incoming international telephony, hubbing services for international carriers and roaming and signaling services for cellular operators. 012 Smile offered broadband and traditional voice services to a wide audience, which included residential and business customers, including small office-home office, or SoHo, customers, small-medium size enterprise, or SME, customers, and large corporate customers, as well as international carriers and cellular operators. 012 Smile provided these services through its integrated multipurpose network that was deployed through points of presence throughout Israel and in England, Germany and the United

States.

012 Smile focused on presenting a "one-stop shop" solution to residential and business customers by offering a diverse package of solutions. 012 Smile invested heavily in its multipurpose network infrastructure, which had been specifically designed to transmit data using IP. 012 Smile's multi-purpose network supported broadband and traditional voice services across Israel, as well as dial-up, ADSL, ISDN and cable broadband services. Its network configuration supported the convergence of voice and data services, such as broadband Internet access, VoB and traditional voice services, as well as advanced technologies. In addition, 012 Smile used its network to provide specialized data services to bandwidth-intensive organizations and international carriers using a variety of technological solutions to satisfy the demands and changing needs of its business customers.

C. Organizational Structure

Eurocom Communications, our controlling shareholder, is the beneficial owner of 78.97% of our ordinary shares (15,164,929 ordinary shares) as of April 30, 2012. Mr. Shaul Elovitch, our chairman and the chairman of the board of directors of Eurocom Holdings (1979) Ltd., or Eurocom Holdings, holds 80% of Eurocom Holdings' shares and 75% of Eurocom Holdings' management shares, and Mr. Yossef Elovitch, his brother and our director, holds 20% of Eurocom Holdings' shares and 25% of Eurocom Holdings' management shares. Eurocom Communications is 50.33% owned by Eurocom Holdings and 49.0% of its shares are held by four holding companies, which are 80% owned by Mr. Shaul Elovitch and 20% owned by Mr. Yossef Elovitch. The remaining 0.67% interest in Eurocom Communications is directly owned by Mr. Shaul Elovitch. Accordingly, Mr. Shaul Elovitch may be deemed to have the sole voting and dispositive power over our ordinary shares held by Eurocom Communications. Mr. Shaul Elovitch may also deemed to be the beneficial owner of 26,893 of our ordinary shares held of record by his wife, Mrs. Iris Elovitch. In addition 8,300 shares are held by other family members of Mr. Shaul Elovitch.

Eurocom Communications' other principal controlled holdings are: Eurocom Cellular Communications Ltd., the representative of Nokia mobile phones in Israel; Eurocom Industries (1986) Ltd., a holding company that owns Eurocom Digital Communications Ltd., or Eurocom Digital, which markets electronic office equipment and consumer electronic products; Trans-Global Industries PTE Ltd., a provider of customized networking solutions to businesses based on telephone network equipment and home digital telephones; Satcom Systems Ltd., a global provider of satellite broadband communications services and Gilat Satcom Ltd., a fully owned subsidiary of Satcom Systems Ltd., which specializes in providing fixed and mobile communication services via satellite; Space-Communication Ltd, the owner and operator communication satellites; Satlink Communication Ltd, a satellites serviced provider; E,G,R,E Ltd. Eitag Ltd. and Eurocom Real Estate Ltd, a real estate companies; Enlight Renewable Energy Ltd. which specializes in initiating, developing, constructing and operating clean electricity production projects from renewable energy sources.

We operate through one principal subsidiary, B Communications, which is the controlling shareholder of Bezeq, Israel's largest telecommunications provider. B Communications interest in Bezeq is directly held by SP2, which is a wholly-owned subsidiary directly held by SP1. As of April 30, 2012, we have a 31.05% ownership interest in Bezeq through our 79.94% ownership interest in B Communications.

D. Property, Plants and Equipment

Effective as of June 1, 2011, our corporate headquarters are located in a 30 square meter facility in Ramat Gan, Israel, which we lease from Eurocom Communications at a token rent. The lease is for a three-year period, which may be extended each year for an additional one year period on the mutual consent of the parties. Goldmind also leases a small space in Rehovot, Israel.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. Operating Results

The following discussion of our results of operations should be read together with our audited consolidated financial statements and the related notes, which appear elsewhere in this annual report. The following discussion contains forward-looking statements that reflect our current plans, estimates and beliefs and involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include those discussed below and elsewhere in this annual report.

Adoption of IFRS

Effective as of January 1, 2009, we adopted IFRS as issued by the IASB, replacing the previous reporting standard which was U.S. GAAP. Accordingly, beginning January 1, 2009, we prepare our consolidated financial data according to IFRS as issued by the IASB. Our transition date to IFRS under First Time Adoption of International Financial Reporting Standards was January 1, 2008.

Our Legacy Communications Business

Prior to January 2010, we were a communications services provider in Israel and offered a wide range of broadband and traditional voice services. Until our initial public offering on October 30, 2007, we were a wholly-owned subsidiary of Internet Gold, a public company traded on the NASDAQ Global Select Market and the TASE, whose shares are included in the TASE-100 Index. Internet Gold is controlled by Eurocom Communications, one of Israel’s major communications groups. Internet Gold began providing Internet access services in 1996 and began offering broadband services in 2001 and traditional voice services in 2004. As part of its internal restructuring in 2006, Internet Gold transferred to us its broadband and traditional voice services businesses, which we refer to in this annual report as the legacy Communications Business.

On December 31, 2006, we acquired one of our principal competitors, 012 Golden Lines. We completed the execution of our integration plan with 012 Golden Lines in the second quarter of 2008.

On October 25, 2009, we entered into a share purchase agreement to acquire the controlling interest in Bezeq, Israel’s largest telecommunications provider, from Ap.Sb.Ar. Holdings Ltd. On November 16, 2009, we entered into an agreement to sell our legacy Communications Business, excluding certain retained indebtedness and liabilities, to a wholly-owned subsidiary of Ampal for NIS 1.2 billion. The sale of our legacy Communications Business to Ampal was completed on January 31, 2010, effective as of January 1, 2010.

Acquisition of Controlling Interest in Bezeq

On October 25, 2009, we entered into a share purchase agreement to acquire the controlling interest in Bezeq, Israel’s largest telecommunications provider, from Ap.Sb.Ar. Holdings Ltd. for an aggregate cash purchase price of approximately NIS 6.5 billion. On April 14, 2010, we completed the acquisition of 30.44% of Bezeq’s outstanding shares and became the controlling shareholder of Bezeq. We began consolidating Bezeq’s financial results into our financial statements effective as of the closing of the acquisition and began to report the consolidated results in our 2010 second quarter earnings release.

As part of our acquisition of the controlling interest in Bezeq, we, Internet Gold, SP2, SP1 and other members of the Eurocom group applied for authorization to control Bezeq, pursuant to the Communications Law and Communications Order. On April 13, 2010, the control permit was granted subject to the condition that SP2 is controlled exclusively by the other parties to the control permit, referred to as the Companies’ Control Permit. Concurrently, a separate control permit was also granted to Messrs. Shaul Elovitch and Yossef Elovitch, our controlling shareholders, referred to as the Individuals’ Control Permit.

To facilitate the funding of our acquisition of the controlling interest in Bezeq, B Communications entered into a series of long-term and short-term loans. See Item 5B “Operating and Financial Review and Prospects - Liquidity and Capital Resources.”

Overview

Bezeq is the leading provider of communications services in Israel, providing a broad range of telecommunications operations and services, including domestic fixed-line, cellular and international communication services, multi-channel television, satellite broadcasts, Internet services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, television and radio broadcasts, and supply and maintenance of equipment on customer premises, which is referred to as network end point, or NEP services.

Bezeq's management evaluates Bezeq's performance through focusing on key performance indicators, which include among others: number of subscribers, churn rate, average minutes of usage per subscriber, or MOU, average revenue per subscriber, or ARPU, operating income and net income. These key performance indicators are primarily affected by the competitive and regulatory landscape in which Bezeq operates and its ability to adapt to the challenges it faces.

How Bezeq Generates Revenue

Bezeq has four principal operating segments: (i) fixed-line domestic communications; (ii) cellular; (iii) international communications, Internet and NEP services; and (iv) multi-channel television (DBS). Effective August 21, 2009, Bezeq no longer consolidates the results of DBS in its financial statements and its investment in DBS is accounted for under the equity method. In addition to the four principal segments, Bezeq has other areas of operation that are not material to its consolidated operations and they are aggregated in the financial statements as "Other." These operations include a portal and content sites and an online commercial site (through Walla! since the consolidation of its operations in 2010), from the date of consolidation of the Group's reports customer service centers and an investment in a venture capital fund.

Revenue from Bezeq's fixed-line domestic communications segment is derived primarily from fees received for (i) its telephony services, including mainly the basic telephony service on the domestic telephone line, plus associated services such as voice mail, caller ID, call waiting, call forwarding, speed dial, conference calls, public telephones and a unified telephone directory; (ii) inter Internet access infrastructure services in xDSL technology; (iii) data communication services, including network services for transferring data from point to point, transferring data between computers and between various communications networks, services connecting communications networks to the Internet and remote access services; and (iv) other services including, services to communications operators, broadcasting services, contract work, IP Centrex services, data center services, a search engine for finding phone numbers (including a classified search) and new services.

Revenue from the Pelephone cellular segment is derived primarily from fees received from its service offerings, including, voice transmission, transmission of text messages, roaming, data communications and advanced multimedia services. Pelephone also sells cellular phones and devices, modems and laptop computers and offers repair services.

Bezeq International's revenues are primarily derived from Internet access services for private and business customers, including terminal equipment and support, voice services including, international direct dialing services to business and private customers and international call routing and termination services, hosting services, supply of international data communication solutions for business customers and information and communication technology solutions for business customers and PBX services.

DBS's revenues are primarily derived from the sale of subscriptions for its multi-channel satellite broadcast services. DBS offers approximately 150 different video channels (of which 20 are pay per view channels and 10 are High Definition channels) and 20 radio channels, 30 music channels and interactive services. Revenue from subscriptions is recognized ratably over the contract period, which is generally one to 12 months. As of August 21, 2009, the value of Bezeq's investment in DBS was estimated by an independent assessor to be approximately NIS 1.145 to 1,234 billion and Bezeq estimated its investment at NIS 1.175 billion. Based on the estimates, Bezeq recognized a profit of approximately NIS 1.5 billion in its financial statements for the year ended December 31, 2009.

Bezeq also includes a category of "Other" in its consolidated financial statements, which mainly includes customer call center services through its Bezeq Online Ltd. subsidiary, investments in a venture capital fund, a 71.55% investment in Walla! Communications Ltd., or Walla!, a popular Israeli provider of Internet and portal services, whose shares were listed on the TASE until April 2012, at which time Bezeq completed a tender for all of the shares of Walla! held by the public.

Significant Costs and Expenses

Depreciation and Amortization. Prior to the sale of our legacy communications business, our depreciation and amortization expenses primarily related to our legacy communications business network equipment and capacity. Subsequent to B Communication's acquisition of the controlling interest in Bezeq, we adopted Bezeq's policies regarding the depreciation and amortization expenses related to its communications business network equipment and capacity. Depreciation and amortization expenses primarily consist of depreciation on computer equipment, software, leasehold improvements, capitalized software development costs and amortization of purchased intangibles. We expect that depreciation and amortization expenses will increase on an absolute basis as Bezeq continues to expand its technology infrastructure but will decline as a percentage of revenue over time.

Salaries. Salaries include salary costs, social, statutory and employment benefits, and commissions of all our employees. The Bezeq Group's salary expenses primarily consist of operating and general and administrative salaries, benefits, stock-based compensation and incentive compensation.

General and Operating Expenses. General and operating expenses relating to our legacy Communications Business consisted primarily of costs of network services, facilities costs, costs of connecting local telephone lines into points of presence, international termination costs, the use of third party networks and leased lines and other regional network operations centers, telecommunication services expenses related to traditional voice services, agreements with several international carriers, building maintenance, services and maintenance by sub-contractors, vehicle maintenance expenses, royalties to the State of Israel and collection fees. The Bezeq Group's general and operating expenses primarily consist of cellular telephone expenses, general expenses including outside consulting, legal and accounting services, materials and spare parts, building maintenance, services and maintenance by sub-contractors, international communication expenses, vehicle maintenance expenses, royalties paid to the State of Israel and collection fees.

Other operating expenses. Other operating expenses primarily include provision for severance pay on early retirement, capital gains from the sale of property, plant and equipment, provisions for contingent liabilities and loss from copper forward contracts.

Finance Expense. Historically, our finance expense includes exchange rate differences arising from changes in the value of monetary assets and monetary liabilities stated in currencies other than the NIS, as well as interest charged on loans from banks. We also incurred interest expense attributable to our debentures and the debentures of B Communications. We also incurred interest expense attributable to the loans B Communications incurred to facilitate the funding of its acquisition of the controlling interest in Bezeq. Bezeq's financing expenses primarily consist of interest expenses for Bezeq's financial liabilities, linkage and exchange rate differences, changes in fair value of financial assets measured at fair value through profit or loss, financing expenses for employee benefits and other financing expenses.

Income Tax. Income tax expense is comprised of current and deferred tax. Bezeq recognizes current and deferred tax expense in profit or loss except to the extent that it relates to items recognized directly in equity or in other comprehensive income. Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Our assessment considers that deferred tax is recognized using the statements of financial position method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. under our assessment deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously. A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilized. Deferred tax assets are reviewed at each reporting date and are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

The applicable Israel company income tax rate for 2009 was 26% and it declined to 25% in 2010 and 24% in 2011. Under the Income Tax Ordinance the tax rate was scheduled to decline to 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter. However, at the end of 2011 the Knesset passed an amendment to the Income Tax Ordinance pursuant to which the gradual reduction in the tax rate was abolished and the 2010 corporate tax rate of 25% was reinstated for an indefinite period, commencing on January 1, 2012.

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Results of Operations

The following table sets forth our results of operations in NIS in thousands and as a percentage of revenues for the three years ended December 31, 2011 (IFRS):

	Year ended December 31,											
	2009				2010				2011			
	NIS		%		NIS		%		NIS		%	
Revenues	1,243		100		8,732		100	%	11,376		100	%
Depreciation and amortization	99		7.9	%	2,295		26.3	%	2,984		26.2	%
Salaries	171		13.8	%	1,500		17.2	%	2,122		18.7	%
General and operating expenses	811		65.2	%	3,711		42.5	%	4,468		39.3	%
Other operating expenses (income),net	2		0.2	%	(3	)	.03	%	323		2.8	%
Operating income	160		12.9	%	1,229		14.1	%	1,479		13.0	%
Finance expense	134		10.8	%	716		8.2	%	1,077		9.5	%
Finance income	(132	)	(10.6	)%	(327	)	(3.7	)%	(497	)	(4.4	)%
Income after financing expenses (income), net	158		12.7	%	840		9.6	%	899		7.9	%
Share of losses in equity-accounted investee	-		0	%	235		2.7	%	216		1.9	%
Income before income tax	158		12.7	%	605		6.9	%	683		6.0	%
Income tax	58		4.7	%	385		4.4	%	653		5.7	%
Income for the year	100		8	%	220		2.5	%	30		0.3	%
Income (loss) attributable to owners of the Company	62		5	%	(209	)	(2.4	)%	(266	)	(2.3	)%
Income attributable to non-controlling interest	38		3	%	429							