84th ANNUAL REPORT Year 2006

איכות בכל רגע

חברת החשמל
Israel Electric

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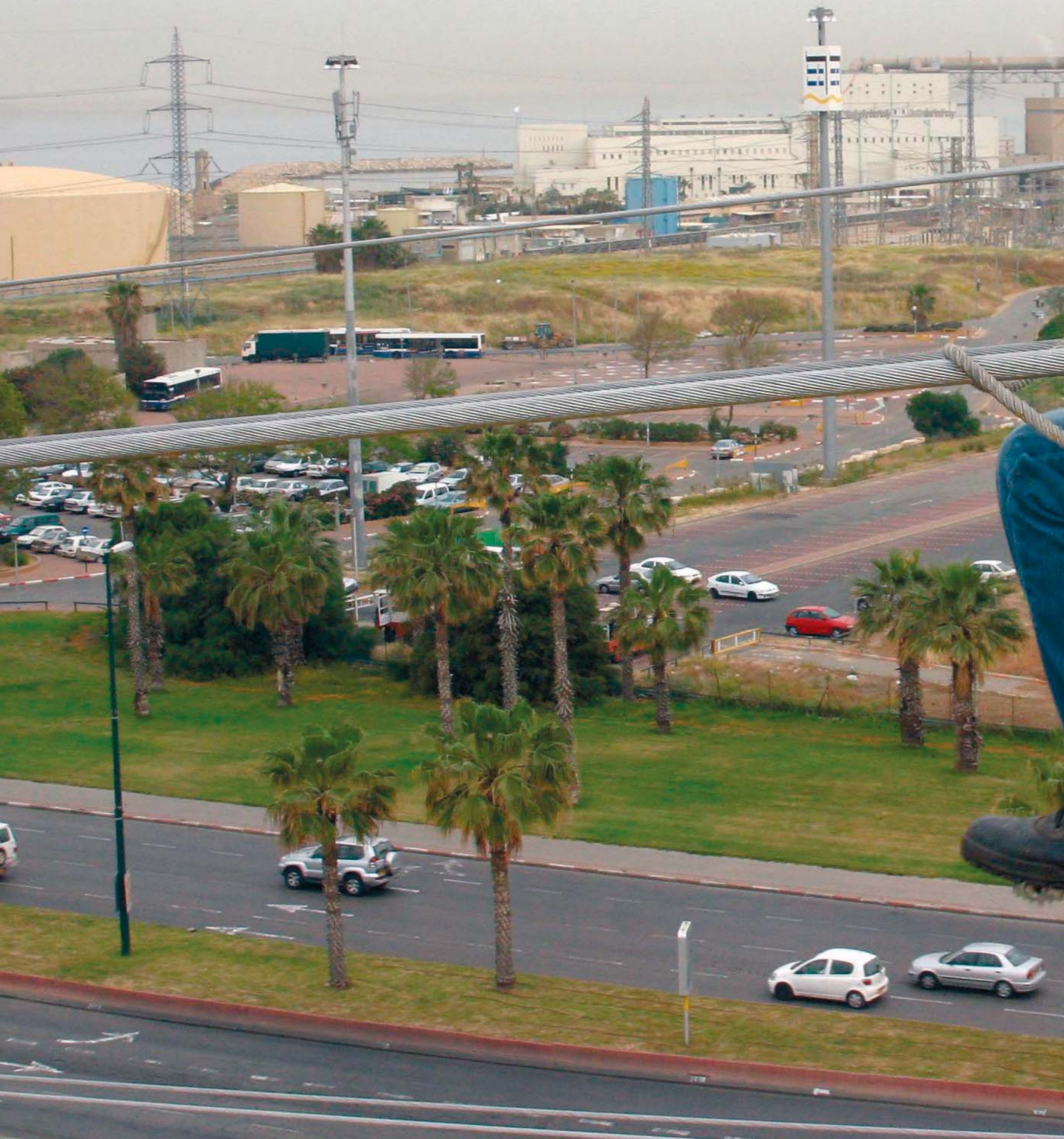
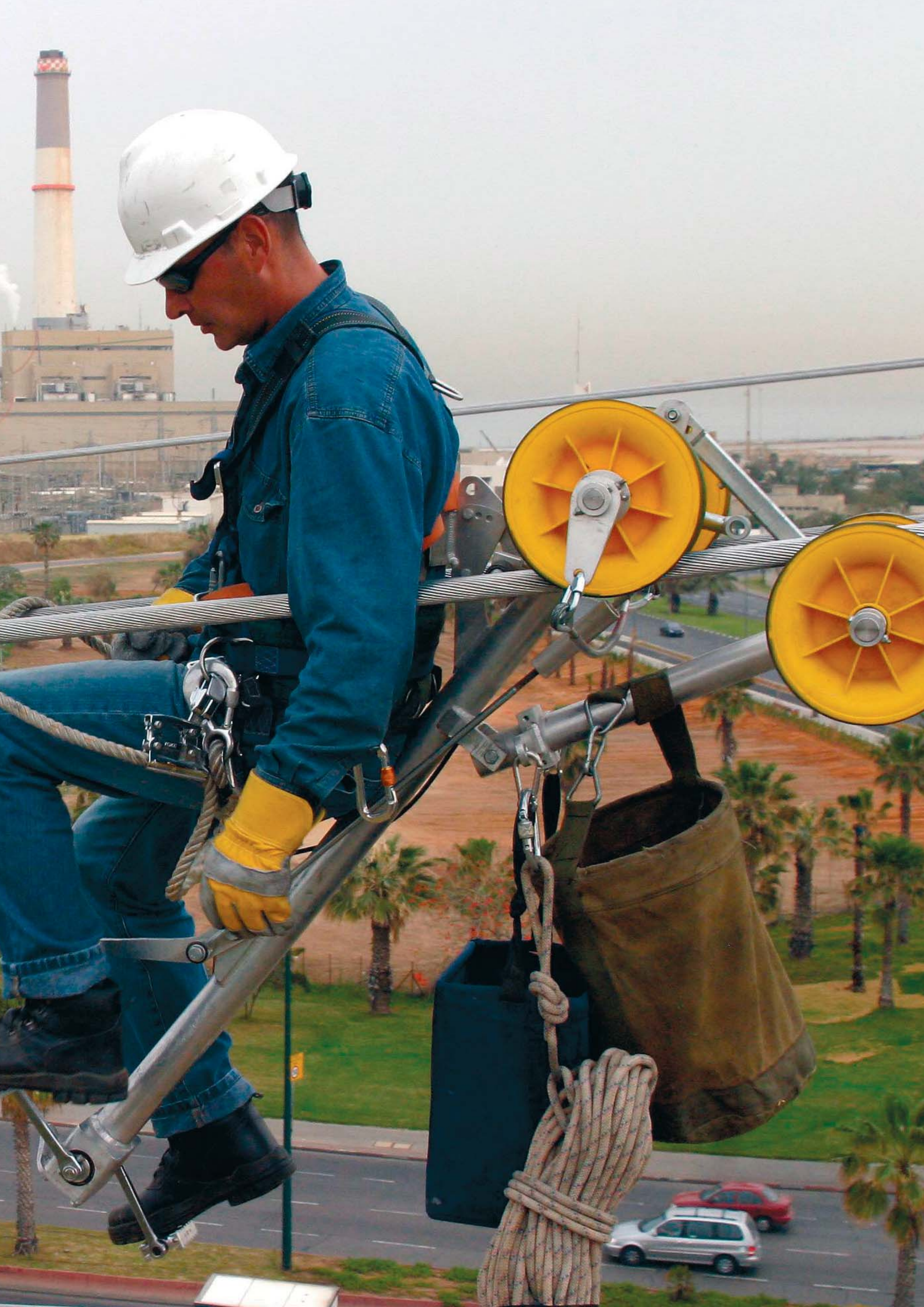




Board of Directors

as of 31.12.2006

Moshe Gavish - Acting Chairman

Shlomit Barnea-Farago

Yigal Cohen-Orgad

Orna Deutch

Rochelle Don-Yechiya

Pnina Dvorin

Dan Ellman

Assad Joubran

Oded Koritshoner

Michael Lazar

Dov Oren

Arie Rosenberg

Ora Sova-Gindin

Israel (Izzy) Tapoohi

Yossef Vadana

Shaul Zemach

Management

as of 31.12.2006

Uri Ben-Noon
President & Chief Executive Officer

Asher Dahan
Senior Vice President
Organization, Logistics, Security &
Emergency Economy

Moshe Bachar
Senior Vice President
Generation & Transmission

Dr. Adrian Bianu
Senior Vice President
Strategic Resources

Avner Yehudai
Senior Vice President
Finance & Economics

Silviu Witinig
Senior Vice President
Engineering Projects

Yigal Ben-Arie
Senior Vice President
Customer Division

Aharon Goldman
Representative of Government Companies Authority

David Yahav, Adv.
General Counsel & Company Secretary

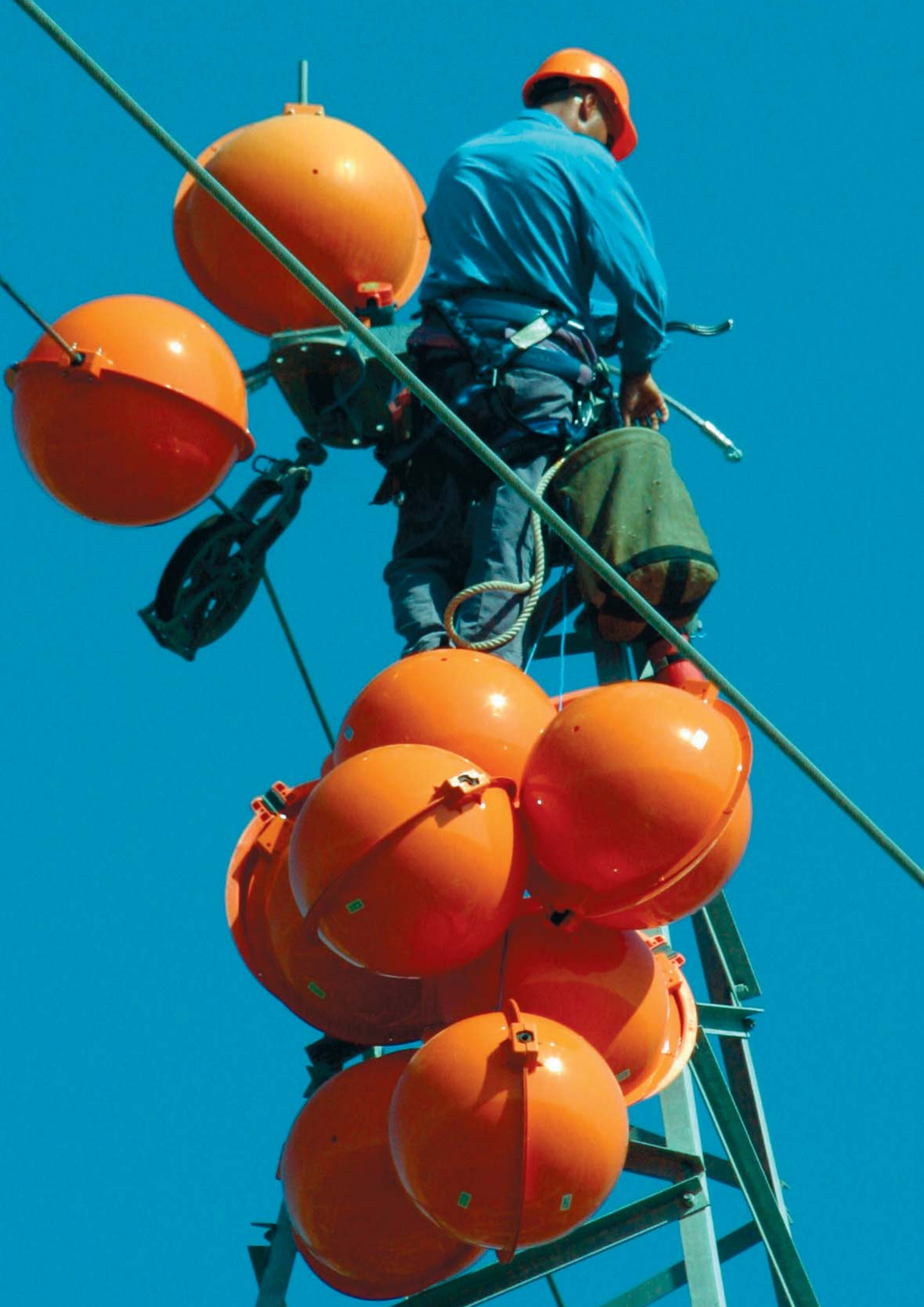
Dr. Eli Sverdlov
Company Auditor & Ombudsman

Daniel Rozner
Secretary to the Board of Directors

Auditors:
Kost Forer Gabbay & Kasierer
Certified Public Accountants (Isr.)
2 Pal Yam St. Haifa, ISRAEL

Brightman Almagor & Co.
Certified Public Accountants
5 Maale Hashichrur St, Haifa, ISRAEL

Registered Office:
1 Netiv Ha'or St. Haifa 31000, ISRAEL



Selected Data as of 31.12.2006

	2005	2006	Annual Change (%)
Generation System			
Installed Capacity (MW)	10,010	10,487	+4.8
Peak Demand (MW)	9,030	9,450	+4.7
Electricity Production (million kWh)	48,379	50,372	+4.1
Load Factor (%)	64.4	60.8	-5.5
Fuel Consumption (thousand tons)			
Fuel Oil	875	686	-21.6
Coal*	12,694	12,665	-0.2
Gas Oil	587	617	+5.1
Natural Gas	1,127	1,541	+36.8
Average Fuel Consumption (gr/kWh)			
Fuel Oil	241	238	-1.1
Coal*	351	355	+1.1
Gas Oil	221	224	+1.5
Natural Gas	201	170	-15.7
Electricity Consumption by Sector (million kWh)			
Total Consumption	44,309	46,175	+4.2
Residential	13,719	14,313	+4.3
Public & Commercial	13,083	13,785	+5.4
Agricultural	1,699	1,755	+3.3
Industrial	10,237	10,387	+1.5
Water Pumping	2,708	2,838	+4.8
The Palestinian Authority	2,863	3,097	+8.2
Income from Sales of Electricity by Sector (million NIS)			
Total Consumption	18,089.0	18,208.4	+0.7
Residential	6,240.6	6,279.8	+0.6
Public & Commercial	5,675.7	5,773.6	+1.7
Agricultural	641.2	643.9	+0.4
Industrial	3,679.1	3,617.5	-1.7
Water Pumping	860.9	850.9	-1.2
The Palestinian Authority	991.5	1,042.7	+5.2
Average Electricity Prices by Sector (agorot/kWh)			
Total Consumption	40.82	39.43	-3.4
Residential	45.49	43.87	-3.6
Public & Commercial	43.38	41.88	-3.5
Agricultural	37.74	36.69	-2.8
Industrial	35.94	34.83	-3.1
Water Pumping	31.79	29.98	-5.7
The Palestinian Authority	34.63	33.67	-2.8
Consumers by Sector (thousands)			
Total Consumption	2,294.3	2,353.8	+2.6
Residential	2,037.6	2,067.9	+1.5
Public & Commercial**	233.0	237.2	+1.8
Agricultural	11.7	10.9	-6.8
Industrial	33.4	33.5	+0.3
Water Pumping	4.2	4.3	+2.4
Permanent Employees	9,727	9,782	+0.6
Electricity Generated per Permanent Employee (thousands/kWh)	4,974	5,149	+3.5

* Nominal quantity of coal.
** Including customers in East Jerusalem & The Palestinian Authority.

CEO and Chairman's Review for the 2006 Annual Report

Mr. Mordechai Friedman
Chairman of the Board of Directors
as of 22.2.2007

Mr. Uri Ben-Noon
President and CEO

Introduction

The Israel Electric Corporation (IEC) has been part of the Israeli scene for over 80 years and its activities are essential for the development and progress of the Israeli economy and for the on-going supply of high quality electric power to the country's population.

In 2006 the IEC faced many challenges. Various events took place during the course of the year which affected the country as well as the IEC: the war in the north of the country, during which the Company's employees, bravely and with dedication, repaired damage to the electric grid, sometimes by putting their own lives at great risk; management of power shortages which occurred at the beginning of the summer and led to acceleration of the Company's development in an attempt to prevent similar situations in the future; and the activities around the anticipated structural changes to the electricity sector requiring the Company to prepare for the implementation of reforms.

Second Lebanon War

The second Lebanon War waged for five weeks, during which almost four thousand Katusha and long range rockets were fired on the entire northern part of the country. On average, one in nine rockets fired caused damage to the medium and low voltage grids leading to disruptions in the regular power supply (approximately 425 hits).

Despite the fact that the state emergency economy program in Israel was not officially implemented, the IEC, as most other infrastructure companies and institutions which provide essential services, was required to continue supplying its services to the public. Hence, from the first day of the war (July 13, 2006), until the cease fire became valid (August 14, 2006), the Company's management and workers continued working untiringly to enable on going power supply to the population of the northern part of the country and to speedily reconnect the homes and shelters which were damaged, to the electric grid.

Shortage Management

Electric power is a product of real time production, subject to immediate real time demand. Since electricity cannot be stored for later marketing, the supply and demand of electricity must be in sync at all times. Every customer that is connected to or disconnected from the electricity flow causes changes requiring all the electric power system components to adjust to the new situation. This means to generate more power or less power, according to the public demand.

The IEC meets the entire electric power requirement to each of its customers at all times. However, there are special circumstances, such as peak electricity demand at times of irregular weather conditions or at times when the reserves* are low due to the need for maintenance work or unplanned shut downs of the generation means, leading to low supply against the demand for electric power.

A shortage management situation is a situation in which the Company knows in advance that it will not be able to supply the energy required at a specific time and in order to balance the power grid, the Company is forced to initiate short power interruptions (up to one hour) equally distributed throughout the various parts of the country.

Several events occurred simultaneously at the beginning of June resulting in the need for shortage management for a period of two days, throughout the country. Following the shortage management, the Company conducted an internal survey to draw conclusions concerning the actions taken for the survivability of the system on the one hand and the efforts in maintaining customer relations on the other. These conclusions were implemented within a short time in the areas of regulations, computer systems and public relations.

The Company upgraded and developed its computer systems for shortage management during regular and in state of emergency operation. These systems allow preplanning of shortage management and help transfer the required information to the Company's customers in general and to the commercial customers in particular.

This information includes specifics of the cities, towns and areas where power interruptions are planned and/or occur, the expected times and duration of the interruptions. This information is sent to the Company's customers via the national communications media (mainly radio and television), the Company's call centers and websites and to commercial customers via SMS messages and/or fax notices.

Demand Side Management (DSM)

The shortage management events were a lever, leading to the Company's intensive and unconventional handling of demand side management. Within this framework, a joint team was established between the IEC, the Ministry of National Infrastructures and the Public Utility Authority - Electricity (PUA) which discussed DSM tariff - peak shifting tariff and tariff for load shedding by diesel generators.

As of the writing of this review, draft criteria on the matter of peak shifting tariff have been published and an agreement for setting up the tariff is being prepared, at the first stage based on the current electricity rate.

Of course, a draft agreement has been prepared to update the tariff criteria for load shedding by diesel generators and to formulate a commitment by the owners of the diesel generators in the agreement.

These actions are expected to lower the demand during shortage management periods by 400 MW: 300 MW by peak shifting and 100 MW by load shedding from independent power producers.

Electricity Level

Furthermore, as part of the conclusions drawn, the IEC has formulated communication strategies aimed at addressing the need raised by the public to know in advance when disruptions are expected in the regular power supply. The Company branded the process as the Electricity Level.

The electricity level is made up of four colors; each color represents a different electricity system status. Using the electricity level, the Company transmits current information to its customers relating to the status of the electricity system via television, radio and the Company's website. Because of this, the Company's customers can prepare for

* The reserve is the difference between the available production capacity and the immediate demand for electric power.

the anticipated shut downs and even implement actions which could reduce and shorten the power interruptions, especially by lower their electricity use during the critical periods.

Shortage Management Exercise

In November the Company conducted a comprehensive exercise to examine the implementation of the conclusions drawn - the 2006 Shortage Management Exercise. The objective of the exercise was to examine and practice the Company's preparations for power shortage management situations, from the aspect of information flow among the Company's various units and between the Company and its customers and the general public, as well as from the operational and organizational aspects. The scenario exercised was based on irregular peak demand on the electricity system so that the Company was forced to implement shut downs of supply lines in order to prevent the collapse of the entire system and to thereby stabilize it. The Company also learnt and drew numerous conclusions from this exercise, which are being implemented by the Company's various units.

Structural Changes in the Electricity Sector

As of March 5, 1996 the IEC operates according to the Electricity Sector Law, 5756-1996. The objective of the Electricity Sector Law is to regulate the operations of the electricity sector for the benefit of the public, which ensuring reliability, availability, quality, efficiency and while creating competitive conditions and lowering costs.

In February 2007, the General manager of the Ministry of National Infrastructures, the budget supervisor at the Ministry of Finance and the Director of the Companies Authority, issued a document that includes their recommendations for the implementation of structural changes in the Company. Based on Government decisions and this document, on March 1, 2007 the Electricity Sector Law was amended - Amendment No. 5, dealing mainly with the Company's structural changes. Moreover, this Amendment also sets forth transition provisions relating to time tables and holding percentages in subsidiaries which will be established due to these structural changes.

The Amendment to the Law defines the gradual transition process to a corporate structure through which the Company will operate several generation subsidiaries which will operate on the basis of a similar fuel mix and which will operate as essential service providers. The Company will later establish and operate several distribution subsidiaries which will each operate in a defined geographic area, and in addition, a transmission subsidiary.

Furthermore, the management of the Company's systems, trade and various functions relating to the electricity sector development and planning will be separated. These operations will be transferred to a separate Government company during the early implementation stages of the reform (towards the end of 2008).

The Amendment to the Law also ascertains that retail operations (sale of electric power to the consumers) will be performed by the generation companies only and that the transmission companies may only deal in this sphere during the defined transition period which will be limited in time.

Moreover, the Amendment to the Law restricts the Company and does not allow it or the subsidiaries that will be established to provide various services to the concern's companies (planning and establishment of power plants, logistics, purchase of fuels and information technologies). Because of this, the concern will be required to establish another company or companies to which these operations will be transferred.

We intend acting, as far as we can, to promote these structural changes. However, the Company's management and Board of Directors are of the opinion that the time tables established in Amendment No. 5 are too short and they doubt the Company's capacity to implement all the required changes within the time tables established in the Law, following this Amendment. Moreover, Amendment No. 5 only partially addresses the gamut of issues raised by the structural changes to the Company and it does not regulate the manner in which these structural changes will be implemented. In the opinion of the Company's management and its Board of Directors, it will not be able to implement the structural changes without reaching an arrangement with the Company's employees, shareholders and other creditors, an arrangement that will ensure that the Company will comply with all its current liabilities towards them, in accordance with the law and contracts that the Company signed.

The IEC employee's union and the General Federation of Labour in Israel object to the changes in the Electricity Sector Law and have declared sanctions due to them. Negotiations have been underway for the past months between the authorized Government bodies, the management of the Company and the employee's union, under the auspices of the Labor Court, with the aim of bridging the gaps and arriving at agreement by the end of 2007, which will enable the implementation of the structural changes.

2006 - Main Activities and Development

During the year under review, the Company continued its development momentum in order to meet the market's ever growing needs. In the long term, the company's main goal is to reliably fulfill the electricity needs according to its obligation as an essential service provider, and at the lowest cost possible.

The ability to provide its customers with reliable, good quality electricity is no small matter, and the responsibility imposed on the Company is vast. Therefore, the Company plans the electricity sector ahead of time, examining several future development scenarios, and making decisions regarding projects according to the available development options.

The Generation System

A decision was taken as part of the Company's approved development plans, to install eight Combined Cycle Gas Turbine (CCGT) units. Most of these units are constructed in two stages - first a gas turbine and then a steam addition - and are presently in various stages of planning and construction.

During 2006, installation of the gas turbines at "Gezer" and "Tzafit" sites were completed. Together, these units supply 454 MW, using gas oil. At the same time, construction of steam addition was started on the two gas turbines at the "Gezer" site. Construction of an additional gas turbine at "Gezer" site started earlier in 2005. Installation of the first steam turbine at "Gezer" site was completed in June 2007 and the second is expected to start generating electricity in March 2008. The CCGT at "Eshkol" site and the gas turbine at "Alon Tavor" site have already been operating for a number of years. At the time of preparing this report, construction of the CCGT at "Hagit" site was completed. The unit was put into production in May 2007. The steam turbine which will complete the combined cycle at the Alon Tabor site is expected to start operating during 2008 and the one at the "Tzafit" site in 2010. Construction has not yet begun on the two combined cycle units at the Haifa site, which are expected to begin generation towards the end of the decade and in accordance with the development plans, will complete the electricity generation system.

These eight generation units will add 3,000 MW using natural gas, to the Company's generation capacity, provided that natural gas reaches all of the electricity generation sites during the indicated time. In the meanwhile, 1,300 MW were installed by the end of 2006. Increasing the generation capacity today and in the future will significantly strengthen the Israeli electricity sector, which has been suffering from low electricity reserves for several years

Independent Power Producers (IPPs)

For the past decade, independent power producers have been given the opportunity to integrate into the electricity sector in Israel, pursuant to the Electricity Sector Law, but to date, the response has been poor. At the end of the reported year, the extent of the Company's engagements with active IPPs stood at 70 MW (approximately 0.7% of the total installed generating capacity). During 2006, only two new IPPs with a total capacity of 6.3 MW entered the electricity sector. Most of the active IPPs (at high voltage and medium voltage) sold electricity exclusively to IEC, and a number of IPPs sold electricity to final consumers and their excess generation to the IEC. In 2006, electricity sales to the Company totaled 150 million kWh, 0.3% of the total electricity generation.

And what does the future hold? By the end of 2006, the PUA granted conditional licenses to entrepreneurs with a total capacity of between 2,000 to 2,700 MW. At this stage, it is impossible to estimate the potential of this additional establishment because the identity, extent and timing of the IPPs in the Israeli electricity sector are still unclear.

Installed Generating Capacity

In 2006, the Company's installed generating capacity totaled 10,487 MW (including 26 MW of IPPs at high voltage)**, an increase of 4.8% compared to last year. Out of this, the generating capacity by using coal is 46.2%; by using gas oil 31.7%; by using fuel oil 5.7%` and the balance is generated by using natural gas.

In practice, electricity generation is determined according to the optimum operational policy, based on minimal generation costs criteria, mainly fuel costs for every kWh generated. Pursuant to this policy, the key fuels used to generate electricity are coal and natural gas (which have the lowest cost per kWh generated ratio) and thereafter, fuel oil and gas fuel (which have the highest cost per kWh generated ratio). This way, in 2006, the Company generated 70.8% of the total electricity generation using coal, 18.0% using natural gas, while fuel oil and gas oil accounted for 5.7% and 5.5% respectively. During the year under review, electricity generation totaled 50 billion kWh.

All-time Peak Demand

A year after the annual peak demand, which stood at 9,030 MW in August 2005, was surpassed, peak demands reached a new record of 9,400 MW in August 2006, following four consecutive days in which peak demand records were broken over and over again. At the end of December 2006, because of the intense cold and rainy weather throughout the country, the all-time demand record was broken when demand reached 9,450 MW. As the Company's available generation capacity at the time was only 9,850 MW, the Company's reinforcement work teams repaired electricity network breakdowns and the Company's generation network did its utmost to provide all of its customers' electricity demands. At the same time, the Company had the opportunity to initiate the tools consolidated within the Electricity Level campaign in real time, including continually conveying information via the media and maintaining a hotline for the general public. During those stormy winter days, the Company indeed kept consumers updated about the electricity reserves, and even asked them to divert using electrical appliances from peak to other times.

Transmission and Transformation System

The national transmission and transformation system comprises two subsystems: The transmission system which includes 161 kV and 400 kV voltage lines and the transformation system that includes transformers which connect the voltage in the transmission and transformation system (from the 400 kV to the 161 kV voltage) and transformers that connect the 161 kV voltage to the medium voltage in the distribution system.

The Transmission Subsystem

During the year, work was carried out on the 400 kV lines, including connecting the new generation units to the electricity network, reinforcing the transmission ability of the existing lines and installing new lines. At the beginning of the year, the gas turbine at the "Gezer" site was connected to the electricity network and at the end of the year the gas turbine at the "Hagit" site was connected. At the end of 2006, the total length of 400 kV extra-high voltage operating lines measured 735 km.

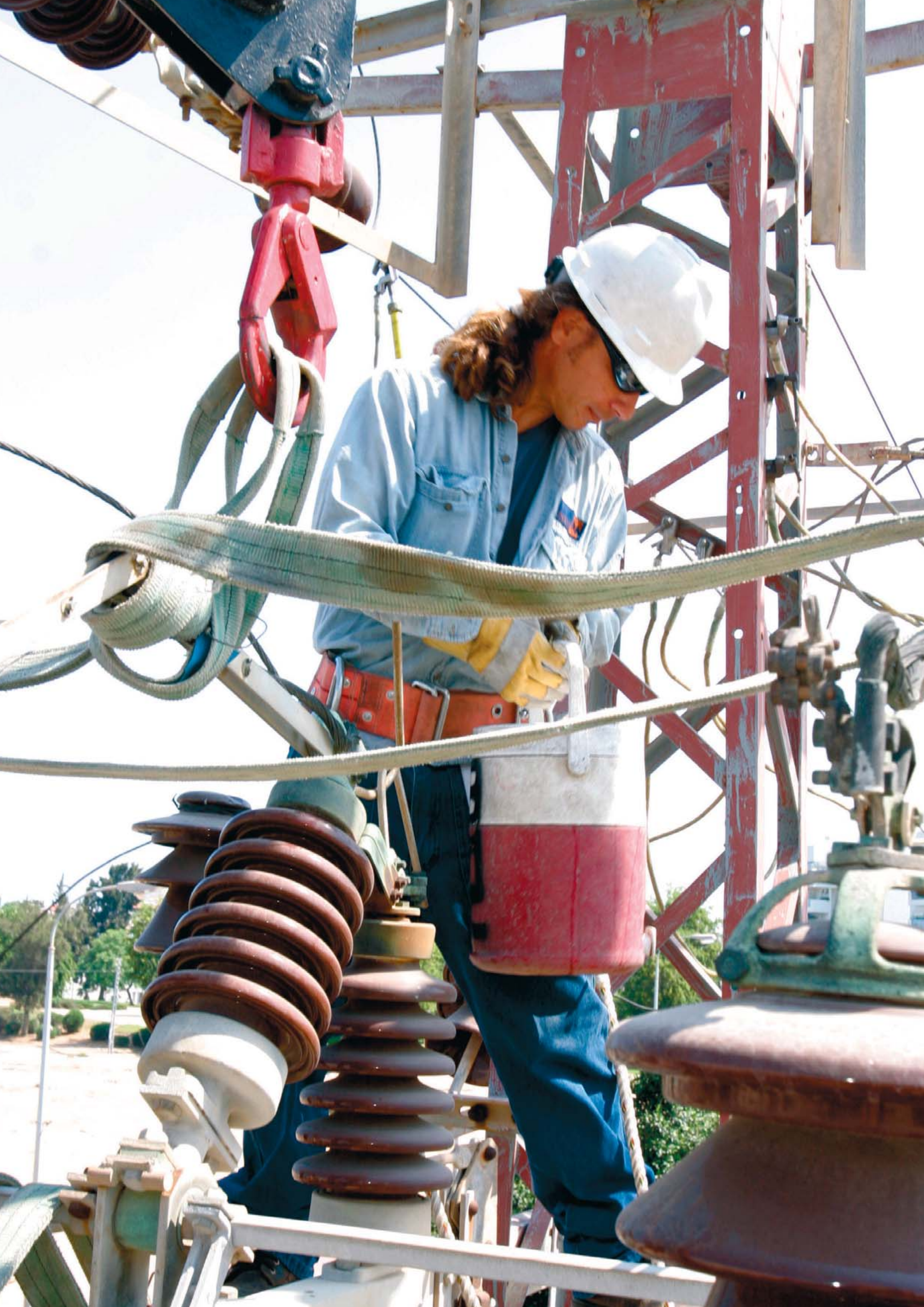
During the year, the transmission system of the overhead 161 kV line was expanded, 18 km of overhead lines were added and 16 km were disconnected (as a result of the improved structure of the 161 kV network). In addition, a number of upgrading projects and the installation of optic fibers using the WRAP method were completed. Therefore, at the end of the year, the length of overhead and underground 161 kV lines in operation amounted to 4,157 km of lines.

The Transformation Subsystem

At the end of the year, the 400/161 kV transformation capacity amounted to 10,000 MVA compared to 9,250 MVA at the end of 2005. This increase was due to the enlarged capacity of the connecting transformers at the various switching stations.

The transformation capacity of the sub-stations (from 161 kV to medium voltage) was also expanded and at the end of the year the transformation capacity from high to medium voltage under the Company's ownership, was 13,415 MVA at permanent, temporary and mobile sub-stations.

** The installed generating capacity as of December 31st 2006 included two units with a generating capacity of 488 MW, for which the Company has not yet been granted licenses (gas turbines at the "Alon Tavor" and "Tzafit" sites); and excludes the installed generating capacity of two combined cycle units at the "Gezer" site of 412 MW, for which the Company has not yet been granted licenses.



The Distribution System

The rate of development of the distribution system was affected by the war in the north and as a result the growth trend in the medium and low voltage distribution network infrastructure slowed down in 2006.

The Medium Voltage Networks

In 2006, the length of medium voltage lines grew by 2.8% compared to the year before, reaching 23,600 km. The share of the underground lines in the grid continues to increase steadily and they form 37% of the total length of the medium voltage network.

The biggest increase in length of medium voltage lines was in the northern district (an increase of 11%), and Haifa district and the southern district (an increase of 7% each). In addition, the number of distribution transformers increased by 1.6%, and an increase of 1.8% was recorded in the installed transformation capacity from medium voltage to low voltage compared to last year.

The Low Voltage Networks

In 2006, the length of low voltage lines amounted to 18,350 km compared to 17,683 km the previous year. As with the medium voltage lines, also here a growth trend can be seen in the share of the underground lines in the grid.

Natural Gas Project

At the beginning of 2004, a revolution began in the Israeli electricity sector when natural gas was introduced into the fuel system used for generating electricity. Natural gas, which is "green" fuel and the clean fuel amongst the hydrocarbon fuels, has a number of advantages, inter alia, a diversity of energy sources for the economy and expanding the IEC's generation capacity, while saving on the costs of fuels and with a significant reduction in the level of pollutant emissions. Since introducing natural gas into Israel, the Company has saved NIS 5 billion in fuel costs, NIS 2.5 billion of which in 2006. In addition, the level of sulfur dioxide emissions and material particles decreased by over 90% and nitrogen oxides by 20-30% at sites using natural gas.

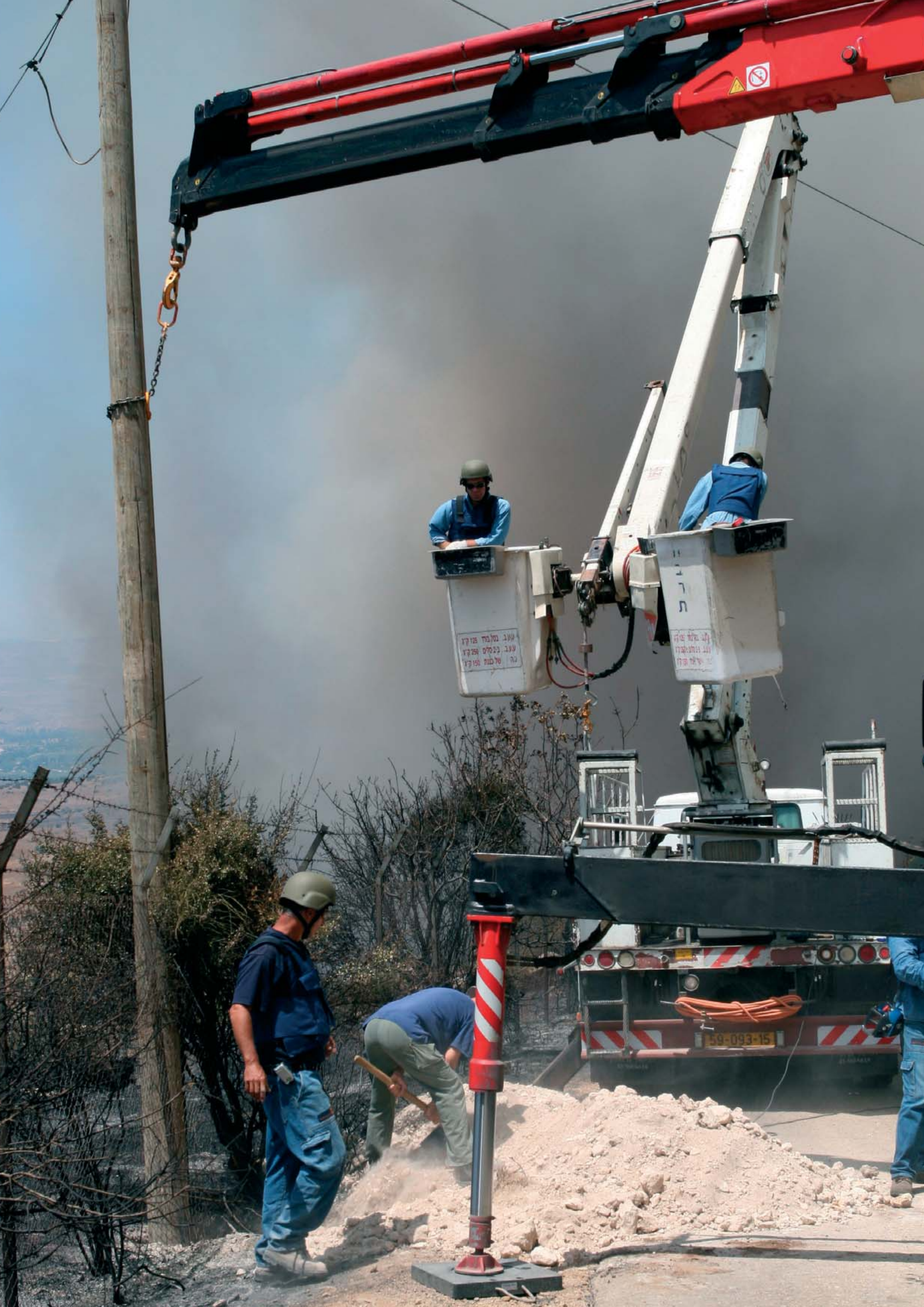
Natural Gas Transmission System

According to the Natural Gas Law, the transmission system is defined as the part that connects the gas suppliers' terminals to the high-pressure gas consumption centers, such as power plant sites, via an underground pipeline system and on onshore gas installations. This system is designed to serve as a monopoly, to be regulated by the Gas Authority, which was established for this purpose.

The national transmission system comprises three main sections: an undersea pipeline, an onshore southern pipeline and a northern onshore pipeline.

According to a tripartite agreement signed between The IEC, Natural Gas Lines in Israel, Ltd (hereinafter: Gas Lines Company) and the Government of Israel, the Company is managing the construction of the undersea pipeline and the section of the northern onshore pipeline from Dor Coast to Hagit power plant on behalf of the Government. The system which is being built by the Company as the construction project manager and financier is owned by the State, which grants the right of use to the Government Gas Lines Company.

In 2006, IEC completed transferring the section of the natural gas undersea pipeline from Ashdod to Reading to the Gas Lines Company, allowing natural gas to flow to the "Reading" power plant installation in Tel Aviv. During 2007, the natural gas transmission system from Reading to Hadera and Hagit is expected to be transferred, enabling operating the "Hagit" site using natural gas. The Gas Lines Company is constructing the section of the system from Ashdod to Ashkelon, including reaching the "Gezer" and "Tzafit" sites. According to the Gas Lines Company's schedule, the "Gezer" site will be connected to the national transmission system during 2007.



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Natural Gas Transmission Agreement

Upon connecting the "Reading" site to the natural gas transmission system, a 15 year agreement was signed between IEC and Gas Lines Company. The agreement regulates natural gas transmission services to the power plants in Tel-Aviv and Ashdod. During 2006, the parties discussed improving the general agreement that will apply to all the Company's sites which will be connected to the natural gas transmission system. The agreement also regulates the ordering capacity to each of the Company's sites, as well as the rights and obligations of each party. As at 2006, the price of natural gas transmission constitutes approx 10% of the price of natural gas supplied.

Significant Achievements During 2006

In 2006, the "Reading" power plant was connected to the national natural gas transmission system and since July 2006 has been using natural gas in place of fuel oil, joining the "Eshkol" power plant, which has been using natural gas since February 2004. During 2006, approx 2.3 billion cubic meters of natural gas were consumed in power plant sites (during 2006 the amount of electricity generated by using natural gas was 18% of the Company's total generation). Due to the huge rise in liquid fuel prices, IEC saved approx NIS 2.5 billion in fuel costs by moving to generation by natural gas. Most of this saving was transferred to electricity consumers.

In addition, when the "Reading" site started using natural gas, an agreement between IEC and the Israeli gas supplier, Yam Tethys Group was signed, to purchase additional quantities of natural gas in spot arrangements, at times of electricity record demand.

Contract for Importing Natural Gas

In August 2005, a long-term contract was signed with a second supplier, the Egyptian EMG Company (Eastern Mediterranean Gas). During 2007, EMG is expected to construct an undersea pipeline to transmit natural gas from El-Arish to the EAPC (Eilat-Ashkelon Pipeline Company, Ltd.) installation near Ashkelon. The Gas Lines Company will transport the Egyptian gas from the national natural gas transmission system to the Company's generation units. The target date for supplying Egyptian natural gas to Israel is the first quarter of 2008, provided there are no delays in obtaining the permits required in Israel for constructing the supplier's facility..

Financial Operations

As it does every year, the Company publishes financial statements for the Company in general. In pursuance of the Government Companies Authority's requirements, the Company includes information regarding the split of the statement of operations and the balance sheet attributed according to the three activities segments of generation, transmission and distribution. In addition, since 2004, a section dealing with "A Description of the Corporation's Business Activities" is being published. This was in pursuance of amendments made to the Securities Regulations (Periodic and Immediate Reports), 1970. The main subjects covered in this section detail the Company's business activities for each of its three main activities segments and for the Company in general. Additional data about the Company's financial operations can be found in IEC Annual Report attached to 2006 Annual Report portfolio (this document is also published on the Company's website).

Main Results of the Statements of Operation

In the reported year, the Company's revenues reached NIS 17.6 billion, which is an increase of 5% compared to the previous year, stemming from an increase in the Company's revenue from electricity sales, resulting from a 4.2% increase in electricity consumption and a real increase of 0.67% in the average revenue per kWh.

Cost of Fuel (including salaries component of fuel costs) increased by 3.15%, amounting to NIS 8.2 billion, an increase of only NIS 0.25 billion compared to the previous year. This increase stems mainly from the increase in fuel prices (gas oil and fuel oil) and in quantity of natural gas consumption. The cost increase was deducted from the drop in coal prices and quantity of fuel oil consumption.

Operating Expenses (excluding depreciation and fuels) increased by 12.5% and totaled NIS 3.5 billion, an increase of NIS 0.4 billion compared to the previous year. The increase can be explained mainly by the rise in expenses of operating a generation system, the increase in management costs resulting damage caused by the war and provisions for the natural gas transmission project, as well as the increase in costs of operating the transmission and distribution systems.

Depreciation Expenses amounted to NIS 3.1 billion, which is an increase of NIS 0.2 billion compared to the previous year. The increase stems from the investments activated during the year, mainly at the power plants and in the gas turbines and networks.

Income from Current Operations decreased slightly compared to the previous year (decrease of 0.95% compared to the previous year), and amounted to NIS 2.5 billion.

Net Financial Expenses amounted to NIS 2.2 billion, a net increase of 13.75% compared to the previous year. During 2006, the Company's basket of foreign currency financial liabilities weakened (a real revaluation) and increased the Company's revenue from the erosion of the liabilities. Despite the weakening, the Company's expenses increased compared to the previous year, mainly due to the hedging transactions in foreign currency.

Other Expenses (Income), net amounted to NIS 7 million, an increase of NIS 15 million compared to the previous year.

Income from Current Operations before Income Taxes during the reported period totaled NIS 332 million, a reduction of NIS 272 million compared to the previous year.

Deferred Income Taxes in the reported year totaled NIS 88 million in expenses compared to the previous year of NIS 673 million in income. In 2005, income included NIS 837 million due to changes in deferred income taxation rates (due to an amendment to the Income Tax Ordinance [No. 147], 2005 which determines the taxation rates applying to the Company will be reduced gradually from 34% in 2005 to 25% in 2010 and onwards).

The Company ended the year with a **Net Income** of NIS 253 million, a reduction of NIS 1.03 billion compared to the previous year. As mentioned before, the previous year's data includes a large one-time income because of changes in the Company's deferred income taxation rates.

International Financial Reporting Standards - IFRS

In July 2006, the Israel Accounting Standards Board published Accounting Standard No. 29 - Adoption of International Financial Reporting Standards (IFRS). Pursuant to this standard, companies which are subject to the provisions of the Securities Law, 1968 and which are required to report according to the regulations published thereunder, will be required to prepare their financial statements in accordance with IFRS standards, as of January 1, 2008.

IEC considers implementing IFRS standards a top priority and invests substantial time and resources in doing so. The Company has divided implementation of the project into three stages:

Stage A: Mapping and identifying the differences between the current accounting principles implemented by the Company compared to IFRS..

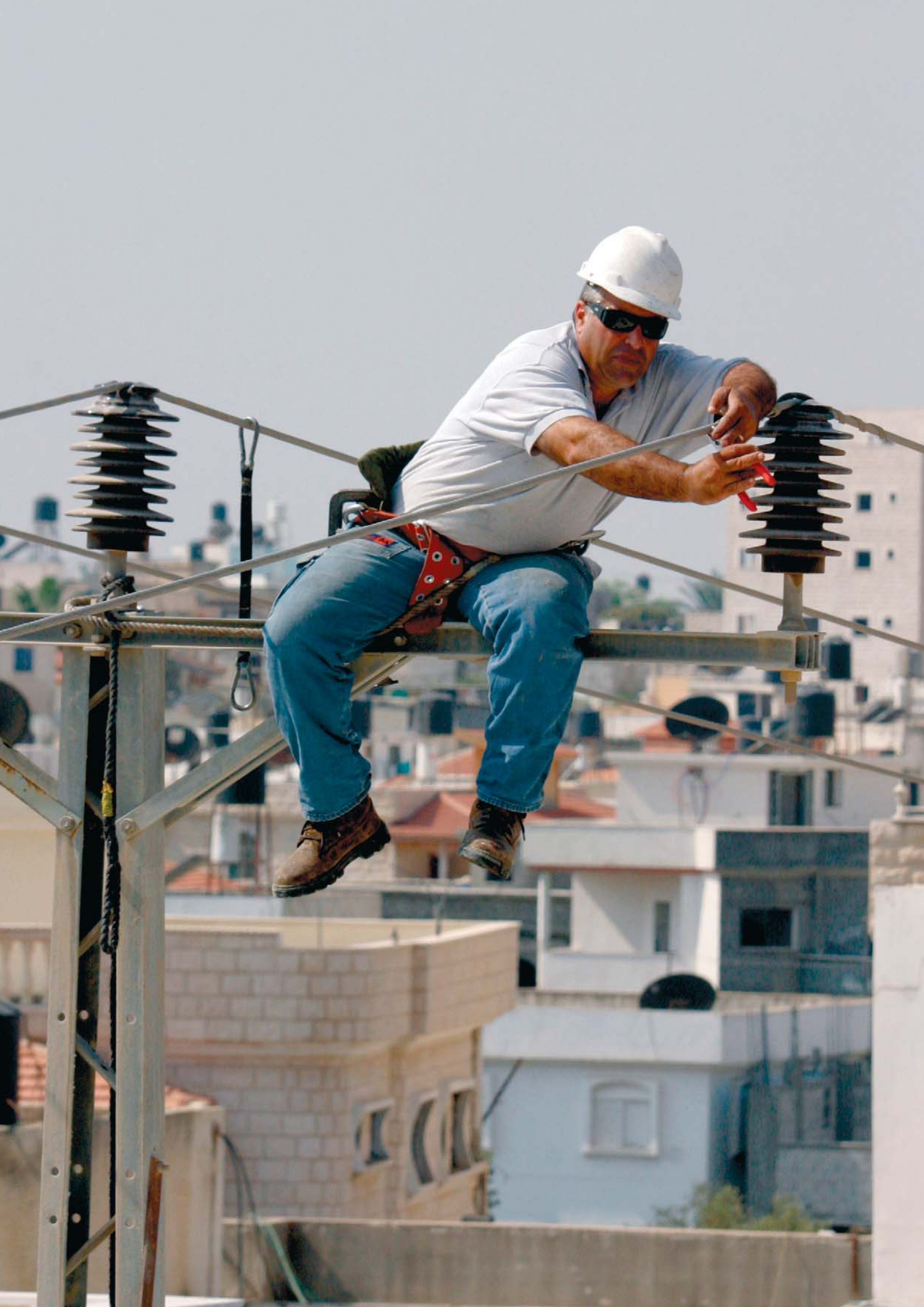
Stage B: Identifying the changes required in business processes and work methods, analyzing and implementing solutions.

Stage C: Implementing the changes, preparing an opening balance as of the date of the transition (January 1, 2007) and re-preparing the financial statements for the year 2007 on a quarterly level.

At the time of signing the financial statements, stage A was completed and five international standards were found which could have significant influence on the Company.

Raising of Capital in Israel and Abroad

The IEC's comprehensive development plans are financed, among others, by capital raised in Israel and abroad. From the beginning of 2002, the Company decided to reduce its exposure to foreign currency, and focus on raising capital in the domestic market by issuing bonds to institutional bodies: Provident funds, pension and advanced-study funds, insurance companies and banks.



Pursuant to this policy, a major part of the capital raised during 2006 was implemented by issuing private bonds in Israel. The Company raised NIS 2.0 billion by three separate issues of two series of private, non-marketable, index-linked bonds for a period 11 years.

An additional NIS 1.2 billion was raised abroad through a loan for importing equipment. In 2006, a total of NIS 3.2 billion was raised.

As of the writing of this review, the Company is preparing additional issues of the two series of private bonds in Israel mentioned above, for a period of 10 years.

It is important to note that IEC's board of directors thinks that raising capital to fund development plans without simultaneously increasing income by electricity rates will make it difficult for the Company to continue investing in generation and supply systems, and will also damage its ability to fulfill its obligations. The Company has informed the stock exchange of these difficulties.

Contrarily, development of the Israeli electricity sector must continue in order to ensure reliable electricity supply at all times. Therefore, the Government of Israel, via its various branches, must guarantee to continue the obligated development and strengthen the Company's financial strength.

Current Operations

In addition to its central activities of electricity generation, transmission and supply, in 2006 the Company continues its current operations which include: Inter alia, Involvement in the community and diverse activity in many areas, preserving the nature and the landscape, continual dialogue with its customers, promoting human resources, and working with the Public Utility Authority - Electricity.

Available Service at all Times and Everywhere

The Company's marketing strategy focuses on positioning the Company as a competitive business entity that focuses on the customers at the highest level. Based on this strategy, IEC invests vast resources on improving customer service and fulfilling their changing needs.

The major contact and service with the public is conducted via the Company's five districts which are spread out throughout the country. By the end of 2006, the Company's customers numbered more than 2.3 million.

The Southern District, IEC's largest district, serves 40% of the Company's customers. In 2006, the district provided services to 931 thousand customers compared to 913 thousand in 2005.

The Dan District, IEC's most densely populated district, provided services to 523 thousand customers compared to 518 thousand in 2005.

The Northern District, which spreads out over the entire northern part of the country (excluding Haifa and its surroundings), provided services to 379 thousand customers compared to 372 thousand in 2005.

The Jerusalem District, which because of its location is responsible for most of the Company's regular work conducted in Judea and Samaria (the West Bank) provided services to 262 thousand customers compared to 257 thousand in 2005.

The Haifa District, characterized by its dense urban environment, provided services to 260 thousand customers compared to 258 thousand in 2005.

Customer Relationship Management (CRM) and Establishment of Contact Centers Project

The customer relationship management project is planned to be implemented in two stages: During the first stage, 19 of the Company's 103 call centers will be consolidated into five Contact Centers (CC), which will be activated in stages at the Company's five districts. The contact centers will be upgraded from a technological aspect to enable service representatives to provide uniform and identical services to each customer as well as enabling access via a range of channels: Telephone, fax, email and the Internet. During the second stage, a new Customer Relationship Management (CRM) computer system will be activated, which will connect the contact center computer systems and manage a customer file documenting all information about the customer. In view of this, it will be possible to provide a full response to a customer's request at a single contact by a single service representative.

In February 2007, the first service center was activated in the Dan district. Service centers in the rest of the districts will be activated in stages by the beginning of 2008.

ERP System

During 2002, the IEC adopted a strategic decision to use the ERP (Enterprise Resource Planning) system to enable the Company to provide a suitable computerized response to the changing business environment. An ERP system makes it possible to manage the computerized setup in any organization with the aid of a single data base, application and user interface. Within the framework of the project, the existing information systems will gradually be replaced, while simultaneously integrating new systems into additional business areas, which were not computerized in the existing systems.

The project is executed in three principal stages: **Stage A - the financial module** was completed in 2005, even though implementation was delayed due to IEC employee's union sanctions. It will replace a major part of the existing financial, bookkeeping and monetary systems. **Stage B - inventory, purchasing and contracts, and human resources** - during 2006, work on stage B continued and is near completion. The target date for the implementation of this stage is during 2007. **Stage C - maintenance management, project management and sectorial solutions for the electricity companies** - during 2006, work continued on stage C and is presently at various stages.

As of writing of this review, IEC employee's union sanctions are continuing, which is delaying implementation of the completed stages.

The Company's Environmental Policy

The Company has adopted an environmental policy favorable to preserving the environment in which we work and live, and awareness thereof. Pursuant to this policy, IEC strictly complies with all the existing environmental requirements, laws and regulations in Israel related to its operations. In instances where there is no legislation, the Company adopts appropriate criteria.

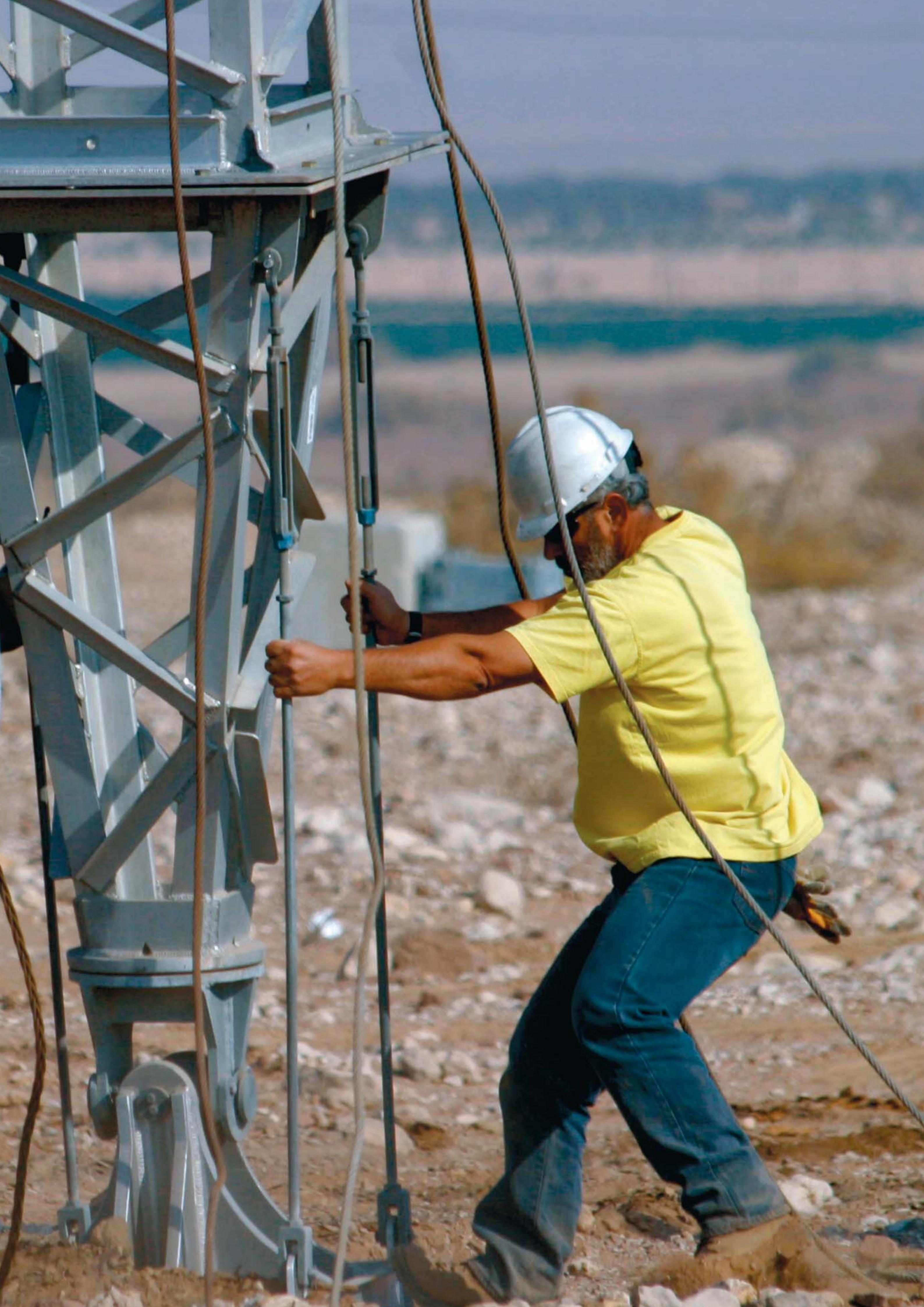
The Company invests considerable resources in its regular operations in order to reduce pollutant emissions during the process of electricity generation. IEC is developing and expanding the use of natural gas, continuously using low-sulfur fuel in the units that still consume fuel oil and quality low-sulfur coal with from an aspect of other pollutant content for the units that consume coal.

Furthermore, IEC invests vast resources in recycling electricity generation byproducts. In 2006, the Company produced 1.17 million tons of coal ash from coal combustion at the power plants, and 70,000 tons of gypsum from operating a FGD installation to expel pollutants at the Rutenberg power plant. One hundred percent of these materials were recycled. The recycling and reselling these products saved mining 1.4 million tons of raw materials, combustion of 50,000 tons of fuel, and 320,000 tons of carbon dioxide emissions, while simultaneously contributing NIS 21 million to the Company's revenue.

Within the framework of the Company's data transparency policy to the authorities and the public, additional data about the Company's activities in environmental protection issues can be reviewed on the Company's website.

Green-Blue-Orange - The CEO's Award for Environmental Protection

Within the framework of the Company's new tradition which started in 2005, for the second time, this year, an internal Green-Blue-Orange - The CEO's Award for Environmental Protection competition was held. This competition is meant to honor and solute IEC employees personally initiating and contributing toward preserving the environment, as well as instills environment protection values in its employees.



The Company's Involvement in the Community

As a leading industrial organization, IEC has an important role to play in promoting social responsibility and community involvement. Community activity is conducted throughout Israel, is tailored to a wide variety of the population groups, in accordance with their special needs as defined by the community itself. The issue of community activities is diverse and touches a long list of areas: Inter alia, safe use of electricity, science and technology, environment protection, bequeathing a legacy, preserving nature and the environment.

In 2006, the Company continued its community activities, and beside its multi-annual projects, entered into new projects. The most obvious example is **the "Netiv Ha'or" program for promoting safe use of electricity among young communities.** The program was developed following some electricity accidents among children and adolescents. The Netiv Ha'or program was initiated by IEC, and adopted by the Education Ministry and local authorities. The objective is to increase the young community's awareness of the importance in using electricity safely, both in and outside the home. It is a widespread, multi-annual community program in which IEC employees and pensioners volunteer to teach children and school teachers. During the 2005 school year, the test program was implemented in 33 schools, in 4 local authorities. Due to its success, in the 2006 school year, another 300 schools in over 41 cities and local authorities joined the program. The goal was set to implement the Netiv Ha'or program in the next five years in 125 local authorities, in over 1,200 schools and to reach 150,000 students. Recently, expanding the Netiv Ha'or program was approved in the framework of the Company's core multi-annual program.

During 2006, the community activity centered on **the Spreading Wings - Adopting Israel's Eagles and Raptors project** also continued. This project is an example of the unique cooperation between Israel Nature and Parks Authority, IEC and Society for the Protection of Nature in Israel. The aim of the project is to protect Israel's raptor population, some of which are rare and endangered. Simultaneously, it is meant to minimize the damage caused to IEC and the national economy in Israel by large birds being electrocuted on electricity cables.

Company's Visitor Centers

The company operates four visitor centers, three of which are located at the Haifa, Hadera and Ashkelon power plants, and the fourth at the Heftsi-Ba site where the Company's training center is located. Visitors to these centers learn about the behind the scenes activities of the world of electricity generation, the complexity of the operation and the manner in which the Company copes with the various issues on its daily agenda. During 2006, 200,000 people visited the Company's visitor centers.

The Relationship between the Employees and the Company

With the knowledge that human resources are critical to the Company's development, IEC implements a comprehensive social plan offering its 13,000 employees a supportive, healthy and safe work environment, while taking care of their wellbeing and that of their families.

During 2006, taking care of the employees' wellbeing took on new significance due to the Second Lebanon War. The Company assisted employees and pensioners whose homes were hit or living environment was damaged by relocating them in the south and center of Israel; opened centers to absorb employees needing alternative housing solutions at the Heftsi-Ba site and employees center in Ashdod; checked the special needs of employees called up for emergency reserve duty and provided them and their families with the assistance needed; operated a summer camp for employees' children outside the Haifa area and thus allowing the parents to return to work; and after the war, employees from the Haifa district and Northern district and their families were sent on vacation.

Employees' satisfaction in their workplace is evident in the rating given by the business information company, BDI, in cooperation with TheMarker magazine, who rated the 100 top companies in Israel from the employee's aspect. The result showed that IEC continues to lead the rating for the third consecutive year (at the time of preparing this report).

Working with the Public Utility Authority - Electricity (PUA)

The Public Utility Authority - Electricity (hereinafter: PUA) was established under the Electricity Sector Law, 1996. Its function is to determine electricity rates and the methods of adjusting them, and the criteria for the quality of service provided by the Company, as well as to supervise the fulfillment of its obligations in accordance with the said criteria.

The dispute between the Company and the PUA is on numerous subjects with significant financial implications. Therefore, should PUA will not accept the Company's position, this will have a significant affect on the Company's financial results.

Electricity Rate

In 2006, the PUA adjusted the electricity rate three times (March 23, September 21 and October 12). Since the beginning of the year, the average residential rate dropped by a nominal accumulated rate of 3.51% (the average rate dropped by 3.36%). This drop was mainly due to the substantial decrease in fuel prices, a reduction in the Company's gas incentives portion as a result of the switching to natural gas (and increasing the portion transmitted to the consumers), revaluation of the NIS against the Basket of Currencies of the Bank of Israel and applying the coefficient reduction factor to the rate.

It is important to note that the present electricity rate does not give the Company the required return of capital. Therefore, in the last few years, the Company has shown low profitability and cash flow dependent on raising capital externally in order to continue its activities.

Summary

The IEC today stands in the face of significant changes demanded by the economic reality in Israel and the world, and the Electricity Sector Law. We at IEC are doing our utmost to promote the structural change - in accordance with the requirements - to the benefit of the electricity sector, IEC and its employees.

Change is not an easy process, but every change also conceals opportunity. We believe that IEC within the new structure will continue generating and providing quality electricity to every home in Israel and to over two million customers.

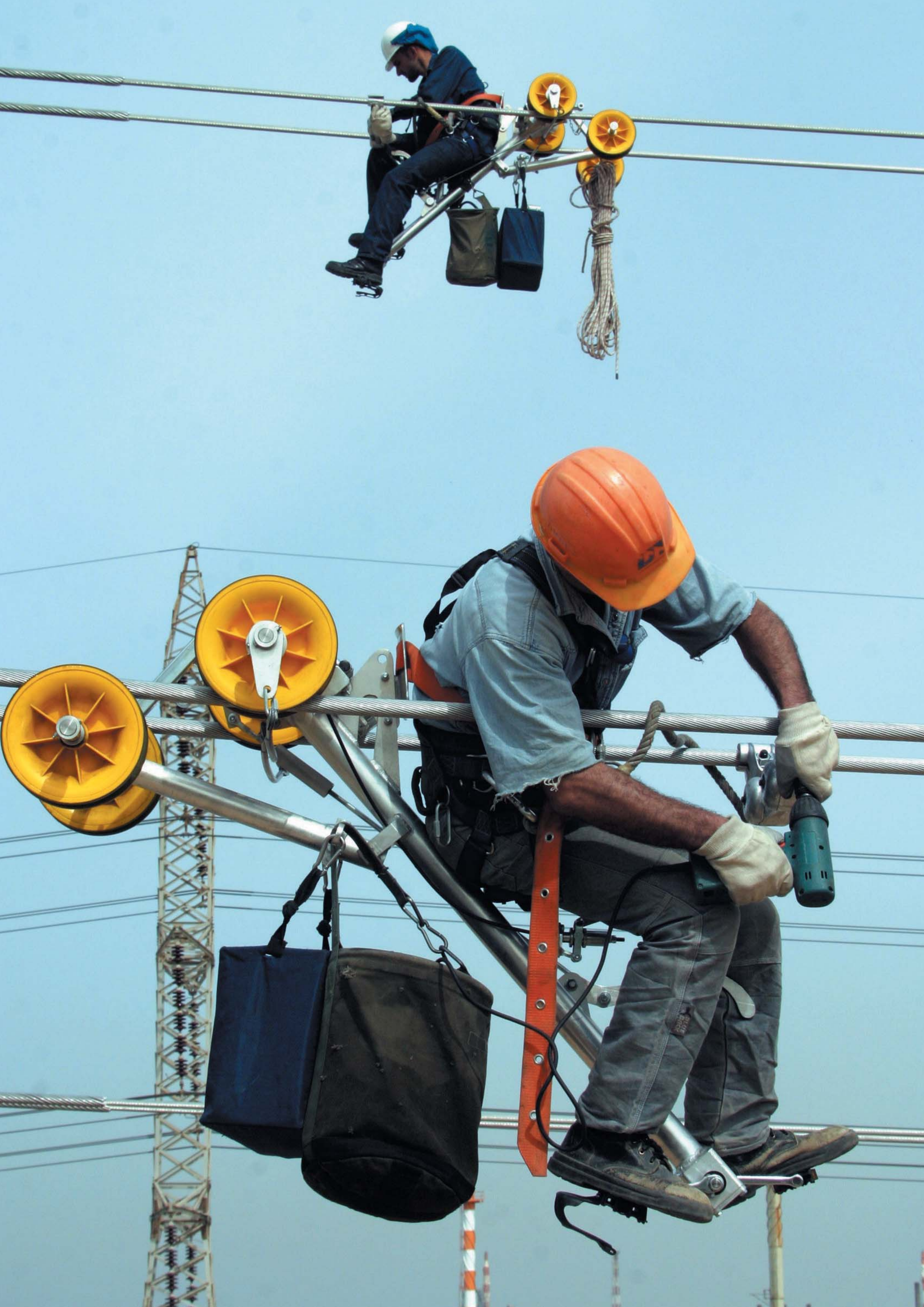
This is also an opportunity to express our appreciation of the employees, members of the management and Board of Directors members for the devotion, loyalty and professionalism demonstrate during their routine work. All the aforementioned achievements and operations, and many others that are too numerous to mention, would have been impossible to attain without their contributions.

We express special thanks to the outgoing CEO, Dr. Jacob Razon, who completed his term of office in March 2006 after working in the company for 45 years.

In addition, we express our gratitude to member of the Board of Directors, Mr. Moshe Gavish, who served as acting Chairman of the Board of Directors until February 2007, and guided the members of the board in taking important decisions required for the continual functioning of the Company.

Mr. Mordechai Friedman
Chairman of the Board of Directors

Mr. Uri Ben-Noon
President and CEO



Board of Directors Report - State of Affairs of the Company

For the year ended December 31, 2006.

The Board of Directors of the Israel Electric Corporation are pleased to present their Board of Directors report on the state of affairs of the Company for the year ended December 31, 2006, pursuant with the Government Companies Authority circulars and the Securities Regulations (Periodic and Immediate Reports) (and Amendments), 5754-1994.

A. Brief description of the Company and its business environment

The Company operates and trades mainly in the generation, transmission and distribution of electricity and in the establishment of the infrastructure required for these operations. The Company provides most of the country's electricity needs and its consumer distribution is such that it does not depend on them. The Company is owned by the State of Israel, which holds 99.85% of its share capital and therefore it is a government company and as such the Government Companies Law, 5735-1975 applies to it. As of March 5, 1996 the Company operates in accordance with the Electricity Sector Law, 5756-1996 (hereinafter: the Electricity Sector Law). The Electricity Sector Law replaces the Electricity Concession Ordinance, and the Company continues, as it did in the past, operating and providing its services pursuant to the provisions of the Law. On March 1, 2007 the Amendment No. 5 of the Electricity Sector Law was published. Amendment No. 5 sets forth the Company's structural changes (See Note 1 of the Financial Statements as of December 31, 2006, hereinafter: the Financial Statements).

The Company presents its financial statements adjusted to the consumer price index (CPI) pursuant to the amendment to the provisions of the Government Companies Law issued by the Minister of Finance on June 12, 2006. This amendment allows the Company to present its Financial Statements adjusted, as previously mentioned, to the CPI from January 1, 2004 and until December 31, 2007 (also see Notes 3 and 9C to the Financial Statements)

B. Decisions of the Electricity Authority

The Electricity Sector Law 5756-1996 states that the Company's rates should be set from time to time by the Electricity Authority based on costs. There is a dispute between the Electricity Authority and the Company regarding a series of issues and the most basic amounts. The Authority's refusal to recognize these issues will lead to a significant reduction in the Company's income and to non recognition of part of its assets, which will cause losses and significant erosion of its equity. The list of main issues includes the establishment of combined cycles (see Notes 3 and 5 to the Financial Statements, which refer to writing off of assets to the extent of up to 245 million dollars), setting of a normative fuel basket, compensation for the Reading Power Station not operating on gas and its shut down, and the scope of capitalization of fees and interests for investments (see Note 3.B.6 to the Financial Statements). Furthermore, the Electricity Authority has indicated that the scope of the Company's investments is in excess of the rate coverage and cautioned that the excess investment cannot rely on future rate coverage.

The Board of Directors are of the opinion that further fund raising for financing development programs, without simultaneous increase in revenues will make it difficult for the Company to continue investing in electricity generation and supply systems, and therefore the development plans and investments must be adjusted to the Company's financial abilities. After the balance sheet date, the Electricity Authority took several decisions in connection with the update of the electricity rate and recognized various costs for the purpose of rate coverage. For further information on the matter of the effect of these decisions, see Note 3 to the Financial Statements.

B. Decisions of the Electricity Authority (cont.)

The Company's Board of Directors discussed the disputed matters with the Electricity Authority as mentioned above, and requested an urgent discussion on the Company's business with the Ministers of National Infrastructures and Finance . In its request, the Board stated that the Company has a debt of NIS 45 billion and since the State is the owner of the Company, measures must be taken to prevent a situation in which, due to reckless management of the debt, the State may have to take part in settling the debt by providing guarantees, transferring capital or regulating rate increases as part of the Economic Arrangements Law for 2007 Simultaneously to this appeal, the Board of Directors required that the General Manager furnish it with comprehensive streamlining plans and the Board wishes to ensure the implementation of these plans.

The Board of Directors believe that a solution must be given for the aforesaid debt and for financing the development required for the coming years and that they cannot wait until the completion of the structure changes.

On June 4 and 5, 2006 the Company entered a contract to supply the State's entire electricity consumption. Demand in excess of the supply occurred while the Company was still undergoing planned refurbishment of the power stations, which was meant to be completed by the end of June 2006, and therefore problems arose at several coal units. In order to prevent the breakdown of the electricity supply system, shortage management was introduced while attaining optimal consumer supply.

A summary of the disputed topics and matters, between the Company and the Electricity Authority are as follows:

	Subject	Electricity Authority's position	The Company's position	See Note to Financial Statements
1.	The gas incentive - the rate of fuel cost savings relinquished by the Company as a result of using natural gas.	The Electricity Authority does not intend amending the incentive track that it decided on in June 2002.	The Company has requested extending the incentive period beyond 2006 and to keep it at 15%.	3.a.3.
2.	Advance payments on account of development.	The Authority reduced the amortization coefficient as of April 2004 to an accumulated annual rate of 2.1% at production, 1.3% at transmission, 2.5% at high voltage distribution and 3.7% at low voltage distribution. The Authority decided not to compensate retroactively for previous years when the amortization coefficient was not reduced.	The Company claims that following application of the reduced coefficients for the past 10 years, they should be cancelled or reduced significantly and should apply only to the operations component. Every one percent reduction of the amortization coefficient will raise the revenues by NIS 90 million per year.	3.a.3.
3.	Fuel basket mix for 2006.	Use of low availability values frequently used in NERC countries. The Electricity Authority is willing to consider changes as part of a new rate base for the production section.	Availability values for calculating fuel mix should be based on long term normative parameters.	3.a. 7.a.

B. Decisions of the Electricity Authority (cont.)

A summary of the disputed topics and matters, between the Company and the Electricity Authority are as follows: (cont.)

	Subject	Electricity Authority's position	The Company's position	See Note to Financial Statements
4.	Reading Power Station - postponement of the conversion of the station to natural gas and use of more costly fuels (dark fuel oil).	The Authority had not updated the fuel basket for 2005 so that the fuel basket was calculated under the assumption that the Reading Power Station would operate on natural gas and dark fuel oil during 2005.	In 2005 the Power Station operated with dark fuel oil for reasons that were out of the Company's control and the fuel mix must be calculated accordingly.	3.a. 7.b.
5.	Reading Power Station - Closure in accordance with Ministry of the Environment Order.	The Authority does not recognize the damage caused to the Company as a result of the implementation of the station closure order.	As a result, the Company was forced to generate electricity from alternative stations and using an expensive fuel mix (diesel) and the Company was caused damage in the amount of NIS 170 million in 2006.	3.a. 7.b.
6.	Electricity consumption at the Company's installations.	The Authority rejected the Company's claim that the electricity consumption of the Company's installations is not included in the base rate.	In the opinion of the Company, these are costs used for the Company's ongoing operations and are required for continuing its activities and therefore this cost should be recognized. The damage to the Company amounts to about NIS 30 million per year.	3.a. 7.c.
7.	Recognition of financing costs.	The Electricity Authority rejected the Company's request for recognition of actual interest costs, in other words, the rate of return on State bonds with the addition of 1.23% profit margin and kept the margin at 0.73%. The Electricity Authority is reexamining the matter as part of its preparation of the new rates.	The Company believes that actual interest costs should be recognized, in other words, the rate of return on State bonds with the addition of 1.23% profit margin.	3.a. 7.d.
8.	Spot transactions for the purchase of natural gas.	The Electricity Authority agreed to recognize the said purchase however it set a price limit to be recognized for the Company This price is significantly lower than the actual price of a natural gas spot transaction.	In recognition the cost of spot transaction gas purchases (in addition to the gas that the Company purchases by long term contract) in 2006 the Company made provisions in the amount of NIS 74 million in the event that this issue is not solved. The Company intends examining further natural gas spot transaction purchases for 2007.	3.a. 7.e.

B. Decisions of the Electricity Authority (cont.)

A summary of the disputed topics and matters, between the Company and the Electricity Authority are as follows: (cont.)

	Subject	Electricity Authority's position	The Company's position	See Note to Financial Statements
9.	Losses from non collection of average rate.	The Company requested that the Electricity Authority amend the rate structure so that it can collect the full revenue due to it. In January 2007, the Electricity Authority notified that it is examining the option of updating the peak usage periods as part of its calculation for the new rates.	The Company estimates that usage at different rates instead of one general average rate based on forecasts of distribution, consumers and types of usage do not cover the required revenue. According to the Company's calculations, it incurred losses because of the above in the amount of NIS 231 million in 2006.	3.a. 7.f.
10.	Expenses in respect of pension liabilities.	The Authority accepted the actuary assumption changes that the Company made in 2003, but in its opinion, changes should be made to additional actuary assumptions, especially in respect of the rank increases for pension payments, so that the provisions will be off set one against the other and no additional accepted expense will be added to the electricity rate.	The Company requested from the Electricity Authority to receive rate coverage for a debt originating in distribution of the actuary changes pursuant to IAS Standard 19, which amounted to NIS 2,400 million as at December 31, 2004, by allowing an annual addition of NIS 160 million to the electricity rate for the next 15 years. Furthermore, the Company demands an amount of NIS 600 million for non coverage of ongoing rates resulting from a significant increase in the current pension costs as opposed to the rate coverage for those years.	3.b. 3.
11.	Establishment costs of a combined cycle type of power station.	The Electricity Authority's professional team recommends recognizing the regular establishment costs in respect of each kilowatt installed in the establishment of the combined cycles which are already in advanced stages of establishment.	The Company disputes the professional teams recommendation and believes that all the costs or consumption incurred up until the completion of construction should be recognized. The establishment costs for the said production units are expected to be US$ 245 million above the recognized costs as they appear in the Electricity Authority's calculations.	3.b. 5.

B. Decisions of the Electricity Authority (cont.)

A summary of the disputed topics and matters, between the Company and the Electricity Authority are as follows: (cont.)

	Subject	Electricity Authority's position	The Company's position	See Note to Financial Statements
12.	Attributing wage, financing and depreciation costs to profit and loss for the cost of establishment of fixed assets.	The Electricity Authority's professional team recommends restricting capitalizations for various fixed assets, while allowing partial compensation in rate.	The Company registers and capitalizes costs in accordance with accepted accounting regulations. According to the changes required by the Electricity Authority, the Company anticipates losses for 2006 in the amount of NIS 70 million, for 2007 of NIS 130 million and for 2008 of NIS 180 million (part of these losses are already included in the surplus establishment costs for the combined cycle systems in the previous section).	3.b. 6.
13.	Changing the order for fixing rates for the next base rate.	In its decision of December 2005, the Electricity Authority stated that it intends first fixing the new rate for the production system and then for the distribution system and only at the end for the transmission system.	The Company assumes that the order of fixing rates is important. Fixing the rate first for the production sector, which is the most profitable, and lastly for the transmission system, which incurs the highest losses, is incorrect and it should start with the transmission sector.	3.b. 7.
14.	Standard 12.	The Electricity Authority decided on distribution of assets for the purpose of rate recognition per generation, according to which part of the asset (the Company is not sure of which part) shall be recognized nominally.	A solution should be found within the electricity rate framework for measuring costs according to accounting rules. The affect of Standard 12 on the Company's Financial Statements as if it applied since January 1, 2006 would cause a reduction in equity in the amount of NIS 1,286 million (see Chapter E of this report).	3.b. 9.
15.	Recognition of external costs.	In April 2005 the Authority decided not to recognize external costs that the Company faced. In January 2007 the Electricity Authority notified that it was reexamining this matter.	The Company is insistent in its demand to receive rate coverage for external costs that it carries and sent the Electricity Authority a proposal of a mechanism for recognizing significant external expenses.	3.g 1.

C. Financial state

1. The current assets as of December 31, 2006 were lower than at December 31, 2005 in the amount of NIS 955 million. This reduction stems mainly from decreases in cash and cash equivalents of NIS 499 million, in debtors and debit balances of NIS 296 millions, and in short-term investments of NIS 192 million.

2. Total investment in fixed assets during the reported period came to NIS 3,592 million as compared with NIS 4,606 million during the same period the previous year. A drop of NIS 1,014 million and at a rate of 22%.

3. Investments during the accrued period were as follows:

4. Combined cycle gas turbines (CCGT) in the amount of NIS 7112 million; gas operated power stations and turbines at a total of NIS 426 million; lines to CCGT power stations (including transformers) in the amount of NIS 503 million; 400 kWh lines (including transformers at switching stations) at a total of NIS 73 million; grids (less expenses) at a total of NIS 1,099 million net; computers at a total of NIS 267 million; in other investments at a total of NIS 444 million; as well as an increase in warehouse inventory in an amount of NIS 68 million (stemming from the purchase of inventory in an amount of NIS 619 million set off against distribution to destinations in the amount of NIS 551 million).

5. On December 31, 2006 the Company's long term and fixed very long term liabilities were NIS 39,918 million (see particulars in Section 16.2), and included: NIS 24,714 million in foreign currency, NIS 13,643 million CPI linked, NIS 631 million unlinked and protection transactions (foreign currency swap transactions) at a total of NIS 930 million, of the Company's said foreign currency liabilities: NIS 17,384 million in US dollars, NIS 4,255 million in Euro, NIS 2,987 million in Japanese Yen, NIS 60 million in Swiss Franc and NIS 28 million in Pound Sterling.

6. Furthermore, the company had unredeemable debentures in the amount of NIS 2,098 million.

7. The Electricity Authority decided to transfer the real exposure to the currency basket in the amount of NIS 15.65 billion of these liabilities to the electricity consumers. The Company is exposed to real exchange rates changes for its liabilities, with the exception of those for which exposure is transferred to the consumers as mentioned above, and those used for establishment and for financing costs in respect of capitalization for fixed assets. In order to reduce this exposure, the Company carried out protection transactions as follows:

Purchase of:	**In NIS millions**
US Dollars	8,718
Euro	927
Pound Sterling	459
Swiss Francs	97
	10,201

In exchange for:	
Linked NIS	3,926
NIS	4,126
Euro	1,615
Pound Sterling	1,369
US Dollar	254
	11,290

As a result, the Company generated, as of balance sheet date, a credit balance due to the changes in the various exchange rate differentials of these transactions for a total of NIS 1,089 million (prior to current maturities in the amount of NIS 174 million).

C. Financial state

Furthermore, the Company carried out forward transactions as follows:

For an amount of NIS 3,207 million in US Dollar - NIS transactions
For an amount of NIS 1,373 million in Japanese Yen - US Dollar transactions
For an amount of NIS 487 million in Japanese Yen - NIS transactions
For an amount of NIS 139 million in Euro - US Dollar transactions
For an amount of NIS 98 million in Japanese Yen - Euro transactions
For an amount of NIS 111 million in Euro - NIS transactions
For an amount of NIS 1,115 million in Euro - NIS transactions
For an amount of NIS 163 million in Pound Sterling - NIS transactions
For an amount of NIS 185 million in US Dollar - Japanese Yen transactions
For an amount of NIS 1,267 million in NIS - US Dollar transactions

a. The Company deposited amounts to cover its pension liabilities in a central pension fund, which had a balance of NIS 15,746 million as of the balance sheet date. Furthermore, the Company deposited amounts into a trust account in respect of additional pension liabilities and which had a balance of NIS 838 million as of the balance sheet date.
b. The Company implements the principles of International Accounting Standard No. 19 in respect of actuary distribution changes. Therefore, when presenting the liabilities in respect of employer-employee relations, an amount of NIS 3,873 million is deducted, being the balance of actuarial changes as at December 31, 2006 which has as yet not been recognized.

8. The cash flow from current activities for liability coverage was 9.6% as of December 31, 2006 as compared with 8.49% (for the purpose of uniform basis of comparison, unredeemable debentures and net interest were classified from equity to liabilities) as of December 31, 2005.

9. The current ratio as of December 31, 2006 was 0.89 compared to 1.02 as of December 31, 2005.

10. The ratio of total liabilities to equity was 4.01 as of December 31, 2006 as compared with 4.14 (for the purpose of uniform basis comparison, permanent debentures and net interest were classified from equity to liabilities) as of December 31, 2006.

11. The return on capital for the accumulated period ended December 31, 2006 was at a rate of 1.91% as compared with the parallel period last year (not including unredeemable debentures and net interest in respect and neutralization of revenue for tax rate changes) at a rate of 3.08%.

12. Financial state according to electricity chain sectors

a. The current assets of the production sector as of December 31, 2006 came to a total of NIS 4,803 million, deriving mainly from consumer balances for the sale of electricity in an amount of NIS 2,243 million (this section refers to sectors as per gross revenue ratio), from stocks of fuel (allocated entirely to the production sector) in the amount of NIS 1,620 million and from cash and cash equivalent balances in the amount of NIS 338 million. In the transmission sector, the current assets amounted to NIS 602 million and in the distribution sector the current assets amounted to NIS 902 million, deriving mainly from consumer balances in respect of electricity sales and cash and cash equivalent balances.
b. Net fixed assets as of December 31, 2006 amounted to NIS 23.819 million in the production sector, in the transmission sector to NIS 11,906 million and in the distribution sector to NIS 15,052 million. The direct assets were assigned to the relevant sectors; shared assets (4.5% of the Company's total assets) were allocated according to a distribution key which the Company estimates to be a fair assessment of the assignment of these assets. During the reported period, the Company invested in direct assets in the production, transmission and distribution sectors a total of NIS 1,138 million, NIS 576 million and NIS 1,166 million respectively, and an additional amount of NIS 712 million for shared assets.

C. Financial state (cont.)

12. Financial state according to electricity chain sectors (cont.)

c. 1. The long term loans and securities as of December 31, 2006 amounted to NIS 23,354 for the production sector, NIS 9,043 for the transmission sector and NIS 9,619 for the distribution sector. The long term loans and securities

2. The net liabilities in respect of employer-employee relations were assigned to the sectors according to the actual current wages and amounted to NIS 396 million for the production sector, NIS 39 million for the transmission sector and NIS 277 million for the distribution sector.

d. The current ratio as of December 31, 2006 was 1.17 for the production sector, 0.65 for the transmission sector and 0.45 for the distribution sector. The difference between the sector ratios is derived mainly from the fuel stocks less the fuel suppliers.

e. The liabilities to equity ratio as of December 31, 2006 were 4.73 for the production sector, 3.49 for the transmission sector and 3.30 for the distribution sector.

f. The annual return on capital (computed according to end of period capital) was 10% in the production sector, 2.1% in the transmission sector and negative return of 11.2% in the distribution sector.

D. Results of operations

1. Results of Operations for 2006 compared with 2005

a. The net revenue from the sale of electricity for the reported period, in respect of sales of 46,175 million kWh amounted to NIS 17,483 million compared with NIS 16,670 for sale of 44,309 kWh during the parallel period of the previous year, an increase in revenue of NIS 813 million which is growth of 4.88%.

The peak electricity consumption during the reported period was in December and reached 9,450 megawatt, while the normal available capacity at that time was 9,825 megawatt, as compared with the consumption of the previous year which was August and reached 9,030 megawatt, while the normal available capacity was 9,096 megawatt.

The change in the abovementioned revenues derives from two reasons and they are:

- A total increase of NIS 111 millions resulting from real growth in average income per kWh (increase of 0.67% compared with growth of 9.19% the previous year).
- A total increase of NIS 702 million resulting from increased consumption (increase of 1,866 million kWh which is a growth of 4.21% as compared with 3.20% the previous year).
- Because of consumer shift to Time-of-Use (TOU) for high and very high voltage power supply owing to changes, especially for the largest consumers, in consumer habits in recent years and the flexibility electricity consumers are given for changing their time of use, the Company does not collect the revenues due to it.

b. The amortization costs presented in the profit and loss statement for the reported period amounted to a total of NIS 3,144 million as compared with NIS 2,941 million for the parallel period of the previous year, being an increase of NIS 203 million. This growth is derived from investments in power stations, grids, household connections, substations, power lines, computers, inventory, meters and others.

c. During the reported period, the fuel consumption costs (without the wage component) amounted to NIS 8,082 million and to a total of NIS 8,215 (including the wage component), as compared with NIS 7,833 million (without the wage component) and NIS 7,964 (including the wage component) for the parallel period of the previous year. An increase of NIS 249 million (without the wage component) and of NIS 251 million (including the wage component), being growth of 3.18% (without the wage component) and 3.15% (including the wage component), which is in principle explained as follows:

(1) The increase in the cost of diesel consumption due to a rise in the real price of diesel fuel, in an amount of NIS 487 million (net increase of 25.27% at average cost per ton, as compared with the parallel period of the previous year) plus an increase of NIS 88 million in the quantity of diesel consumed, deriving from the fact that the Reading Power Station was not operational from March until July 2006 due to not receiving permission to operate on dark fuel oil and due to the fact that the Company used other diesel power stations. The additional costs to the Company as a result of this amounted to NIS 170 million and NIS 128 million less the tax effect.

D. Results of operations (cont.)

1. Results of Operations for 2006 compared with 2005 (cont.)

(2) The accumulated increase in the consumption of natural gas in the amount of NIS 308 million, less the reduction in natural gas consumption costs due to the real drop in price, in the amount of NIS 85 million (net reduction of about 7.4% of the average cost per ton as compared with the parallel period of the previous year).

(3) The accumulated reduction in the consumption of dark fuel oil in the amount of NIS 293 million, less the increase in dark fuel oil consumption costs due to the real rise in price, in the amount of NIS 213 million (net increase of about 23.50% of the average cost per ton as compared with the parallel period of the previous year).

(4) Reduction of coal consumption costs because of a real price drop, in the amount of NIS 367 million (net reduction of 9.2% of the average cost per ton as compared with the parallel period of the previous year (, and reduction in the coal consumption costs due to a reduction in the quantity of coal consumed in the amount of NIS 20 million.

(5) A reduction of NIS 80 million in respect of repairs due to the decision of the Electricity Authority.

d. During July-August 2006, Israel was engaged in a war in the north, resulting in damage to Company installations. Company employees were forbidden from going into the field for work that was not for the purpose of repairing the aforesaid damage and many additional employees did not come to work because of orders. The said damages amounted to approximately NIS 24 million. The Property Tax and Compensation Fund (Payment of Compensation) (War Damage and Indirect Damage to Property) Regulations, 5766-2006 (hereinafter: The Regulations) establish that government companies and the general public are not entitled to government compensation for indirect damages caused as a result of payment of wages to employees who were prevented from working due to war (the Company's costs amounted to NIS 14 million). In the Company's opinion, despite it being a government company, it acts according to business considerations, as set forth in the law (Section 4 (a) of the Government Companies Law), in addition to it being a government company. In the Company's opinion, it should not have to bear the cost of financing actions which by nature are in the interest of the State of Israel, even if it is of first degree interest. Therefore, the Company appealed to the CEO of the Ministry of National Infrastructure and the Director of the Government Companies Authority, requesting that the Regulations be amended accordingly.

e. The operating costs for the reported period amounted to NIS 14,889 million (including amortization and fuels) and NIS 3,530 million (not including amortization and fuels) as compared with NIS 14,044 (including amortization and fuels) and NIS 3,139 million (not including amortization and fuels), an increase of NIS 845 million (including amortization and fuels) and NIS 391 million (not including 391 million (not including amortization and fuels).

f. The profit from operating the electricity system during the reported period amounted to NIS 4,147 million, as compared with NIS 3,989 million for the parallel period of the previous year. An increase of NIS 158 million, which is a growth rate of 3.96%.

g. The cost of net pension liabilities for the reported period amounted to NIS 117 million as compared with the total cost of NIS 106 million for the parallel period of the previous year, a net growth of NIS 11 million.

h. The income from regular activities before income tax for the reported period amounted to NIS 332 million as compared with the total income of NIS 604 million for the parallel period of the previous year, a drop of NIS 272 million.

i. Deferred taxes for the reported period amounted to NIS 88 million for expenses, as compared with revenue of NIS 673 million (including income of NIS 837 in respect of the effect of changes in the rate of deferred taxes) for the parallel period of the previous year, a change of NIS 761 million.

D. Results of operations (cont.)

1. Results of Operations for 2006 compared with 2005 (cont.)

j. Financing costs

The increase in financing costs for the accumulated period as compared with the parallel period of the previous year, after transfer to controlled assets and capitalization of financing costs, are as follows:

Analysis of the amount differentials	**Difference**	**For the year ended 31/12/2006**	**31/12/2005**
		In NIS millions	
a. Financing costs (revenue) resulting from real depreciation (appreciation) of foreign currency and changes in the index less the effect of protection transactions and transfer of costs (revenues) from real financing to controlled assets.			
The shift from costs in the amount of NIS 49 million for the previous year to revenues in the amount of NIS 1,905 million this year stems from the shift from real depreciation of the financial liabilities basket at the rate of 0.11% for the previous year to real appreciation at rate of 6.46% for the reported year, which are made up of: Shift from financing costs to financing income	(1,954)	(1,905)	49
Shift from financing income to financing costs for financial protection transactions	1,688	1,211	(477)
Total increase in financing revenues for the reported year, as compared with the previous year.	(266)	(694)	(428)
Increase in financing costs which were transferred to controlled assets as per the Authority's decision on the matter of the Company's exposure to foreign currency and due to the real depreciation of the basket during the parallel period of the previous year to real appreciation during the reported period.	558	646*	88*
Shift from financing costs to financing revenues as a result of changes between known index and index in lieu	(36)	(4)	32
Estimated earnings on negotiable securities	(9)	(9)	-
Estimated earnings on long term debentures	(23)	(23)	-
Total net reduction of revenues from erosion of financial liabilities	224	(84)	(308)
b. Other financing expenses			
Increase of interest costs for the reported period	73	2,692	2,619
Shift from financing income to financing costs for financial protection transactions	20	14	(6)
Reduction in various financing revenues	18	(185)	(203)
Erosion of working capital	(82)	(33)	49
(Earnings) from negotiable bonds	(25)	(25)	-
(Earnings) from long term debentures	(29)	(29)	-
Total reduction in other financing costs:	(25)	2,434	2,459
Total net increase in financing costs, prior to capitalization of financing costs	199	2,350	2,151
c. Capitalization of projects under construction			
Shift from capitalization of financing revenues to capitalization of designated financing costs for the reported period, made up of:			
Shift from capitalization of revenue from erosion of designated loans for the capitalization of designated financing costs due to the shift from real appreciation (9.68%) to real depreciation of 2.35% of the currency of the designated loans.	229	31	(198)
Reduction by capitalization of other interest costs on designated loans due to reduction in the amount of the designated loans.	(14)	56	70
Total transfer from capitalization of financing revenue to capitalization of designated financing costs.	215	87	(128)
Reduction in capitalization of non-designated financing costs, made up of:			
The shift from capitalization of financing costs for the parallel period of the previous year to the capitalization of the financing revenues from erosion of non designated loans for the reported period due to the shift from real depreciation of 1.4% to real appreciation of (4.43%) of the currency basket for non designated loans.	(265)	(238)	27
Reduction of capitalization of other interest costs on non designated loans due to reduction in the rate of the interest capitalization.	(14)	325	339
Total reduction of capitalization of non designated financing costs.	(279)	87	366
Total net reduction of financing costs.	(64)	174**	238
Total increase in financing costs for the reported period as compared with the parallel period of the previous year, after transfer to supervised assets and capitalization:	**263**	**2,176**	**1,913**

D. Results of operations (cont.)

1. Results of Operations for 2006 compared with 2005 (cont.)

j. Financing costs (cont.)

Presented in Financial Statements

		Difference	For the year ended 31/12/2006	31/12/2005
			In NIS millions	
*	Transfer of financing costs to controlled assets		646	88
**	Capitalization of financing costs		(174)	(238)
	Balance of financing costs		1,704	2,063
	Total financing costs		**2,176**	**1,913**

k. Statement of profit and loss pursuant to Accounting Standard No. 12

On January 1, 2004 the Israel Accounting Standards Board Accounting Standard No. 12 became effective, meaning nominal financial statements (with the exception of depreciation which is calculated differently). The effect of Standard No. 12 on the Company's statement of profit and loss should it be implemented in the financial statements, would generate income of NIS 354 million as follows:

	For the year ended December 31, 2006.
	In NIS millions
Revenue	**17,745**
Electricity system operating costs	**13,397**
Gross Profit	**4,348**
Sales and marketing costs	761
General and administrative expenses	762
Net pension liabilities costs	139
	1,662
Income from regular operations	**2,686**
Financing costs, net	**2,224**
Other revenues, net	(5)
Income before taxes on income	**467**
Taxes on income - current deferred	122
Income from regular operations after income tax	**345**
Share in earnings of affiliated companies - net	9
Net income	**354**

Termination of compliance with SFAS 71 generates additional income of NIS 511 million net due to the elimination of supervision liabilities.

For further information in respect of the effect of Standard No. 12 on the financial statements, see Notes 3 b 9 of the Financial Statements.

2. Results of operations for 2005 compared with 2004

a. The net revenue from the sale of electricity in 2004, in respect of the sale of 44,309 million kWh amounted to NIS 16,670 million compared with NIS 14,833 million for the sale of 42,933 kWh in 2004, an increase in revenue of NIS1,837 million which is equivalent to growth of 12%.

The peak electricity consumption in 2005 was in August and reached 9,030 megawatt, while the regular available capacity at that time was 9,096 megawatt, as compared with the consumption in 2004 which was in July and reached 8,550 megawatt, while the regular available capacity was 9,409 megawatt.

D. Results of operations (cont.)

2. Results of operations for 2005 compared with 2004 (cont.)

The change in the abovementioned revenues is derived from two reasons and they are:

- A total increase of NIS 1,361 millions resulting from real growth in rates (increase of 9% compared with growth of 7% the previous year)
- A total increase of NIS 476 million resulting from increased consumption (increase of 1,375 million kWh which is a growth of 3.2% as compared with 2.9% the previous year).

b. The amortization costs presented in the profit and loss statement for 2005 amounted to a total of NIS 2,941 million as compared with NIS 2,843 million for 2004, being an increase of NIS 98 million. The growth stems from investments in power stations, grids, household connections, substations, power lines, computers, inventory, meters and others.

c. In 2005 fuel consumption costs (not including wage component) amounted to NIS 7,833 million and to NIS 7,964 million (including the wage component), as compared with NIS 5,685 million (not including wage component) and NIS 5,796 (including wage component) for 2004, a decrease of NIS 2,148 millions (not including wage component) and NIS 2,168 million (including wage component), which constitutes a growth of 38% (not including wage component) and 37% (including wage component), which in mainly explained as follows:

(1) An increase in coal consumption costs due to a real price rise, in the amount of NIS 688 million (net increase of 21% on the average cost per ton as compared with the parallel period of the previous year), less the decrease in the quantity of coal consumed, in the amount of NIS 25 million.

(2) An accumulated increase in the consumption of diesel in the amount of NIS 554 million, plus an increase in diesel consumption costs due to a real rise in price, in the amount of NIS 564 million (net increase of about 44% on the average cost per ton as compared with the parallel period of the previous year).

(3) An accumulated increase in the consumption of natural gas in the amount of NIS 227 million, less a decrease in natural gas consumption costs due to a real drop in price, in the amount of NIS 19 million (net reduction of about 2% on the average cost per ton as compared with the parallel period of the previous year).

Because of the two events described below, the Company used fuels (diesel and dark fuel oil) at higher cost in place of natural gas and coal:

a. In January 2005 a malfunction occurred at one of the generation units at the Eshkol Power Station which operates on natural gas. This malfunction, which continued until June 2005, forced the Company to use more expensive alternative fuels (diesel and dark fuel oil) in place of natural gas. The use of these costly fuels caused the Company higher fuel costs in the amount of NIS 112 million.

According to the insurance policy which covers the Company in such events, the Company filed a claim with the insurance company for US$ 16 million, being the Company's cost in excess of the excess insurance. As of the date of the signing of this report, no indemnification has as yet been received.

b. Due to worker sanctions, the refurbishment of the Rutenburg and Orot Rabin coal power stations were prolonged. The delay in these stations becoming operable following the refurbishment caused the Company additional costs, especially in respect of the use of expensive alternative fuels (diesel and dark fuel oil) instead of coal. These costs caused the Company increased fuel costs of NIS 180 million. On September 9, 2005 the Electricity Authority decided not to recognize the costs derived from the Company's workers sanctions as part of the coal price. The accounting method and its reflection in the electricity rate will be implemented at the next rate update. The Company estimates that no additional losses are anticipated, other than those included in these financial statements.

(4) An increase in dark fuel oil consumption costs due to a real price rise, in the amount of NIS 346 million (net increase of 40% on the average cost per ton as compared with the parallel period of the previous year), less a decrease in the quantity of dark fuel oil consumption in the amount of NIS 237 million.

D. Results of operations (cont.)

2. Results of operations for 2005 compared with 2004 (cont.)

d. Operational costs in 2005 amounted to NIS 14,044 million (including depreciation and fuels) and to NIS 3,139 million (not including depreciation and fuels), as compared to NIS 11,611 million (including depreciation and fuels) and NIS 2,972 million (not including depreciation and fuels) in 2004, an increase of NIS 2,433 million (including depreciation and fuels) and NIS 167 million (not including depreciation and fuels).

e. The electricity system operating profit in 2005 amounted to NIS 3,989 million as compared with NIS 4,554 million in 2004, a decrease of NIS 565 million, which constitutes a decrease of 12%, stemming mainly from the rise in fuel prices and the use of costly fuels, as mentioned in Section 3 above.

f. The net pension liability costs in 2005 amounted to a total of NIS 106 million as compared with costs in the amount of NIS 82 million in 2004, a net decrease of NIS 24 million.

g. The regular operating income before taxes on income in 2005 amounted to a total of NIS 604 million as compared with NIS 1,095 million in 2004, a decrease of NIS 491 million.

h. Deferred taxes in 2005 amounted to a total NIS 673 million (including revenues in respect of the effects of tax rate amendments in the amount of NIS 837 million), as compared with NIS 603 million (including revenues in respect of the effects of tax rate amendments in the amount of NIS 943 million) in 2004, an increase of NIS 70 million.

i. Financing costs - see the next page.

D. Results of operations (cont.)

2. Results of operations for 2005 compared with 2004 (cont.)

i. Financing costs

There was a decrease in financing costs for 2005 as compared with 2004, after transfer to controlled assets and capitalization of financing costs, as follows:

Analysis of the amount differentials	**Difference**	**For the year ended 31/12/2005**	**31/12/2004**
		In NIS millions	
a. Financing costs (revenue) resulting from real depreciatio (appreciation) of foreign currency and changes in the index less the effect of protection transactions and transfer of costs (revenues) from real financing to controlled assets.			
The shift from revenues due to the erosion of pension liabilities in foreign currency in the amount of NIS 250 million for the parallel period of the previous year to costs due to the erosion of liabilities for the reported period in the amount of NIS 33 million deriving from the shift from real appreciation of the pension liability basket for the parallel period of the previous year to real devaluation during the reported period from (-0.75%) to 0.11%, made up of: Shift from financing revenues to costs.	310	49	(261)
Shift from financing costs to revenues for financial protection transactions	(761)	(477)	284
Total shift from financing costs to revenues for reported period.	(451)	(428)	23
Increase in financing costs transferred to controlled assets during the reported period in accordance with the decision of the Authority in respect of the Company's exposure to foreign currency, due to the real increase in appreciation of the basket during the reported period.	86	88*	2*
Shift from financing revenues to costs as a result of changes between known index and index in lieu.	65	32	(33)
Total net reduction of revenues from erosion of financial liabilities	(300)	(308)	(8)
b. Other financing expenses			
Increase in interest costs during the reported period as compared with the parallel period of the previous year.	35	2,619	2,584
Increase in financing revenues from financial protection transactions	(6)	(6)	0
Increase in various financing revenues	(70)	(203)	(193)
Erosion of working capital	78	49	31
Total net increase in other financing costs:	37	2,459	2,422
Total net decrease in financing costs, prior to capitalization of financing costs	**(263)**	**2,151**	**2,414**
c. Capitalization of projects under construction			
Shift from capitalization of designated financing costs during the parallel period of the previous year to capitalization of designated financing revenues during the reported period, which are made up of:			
Shift from capitalization of financing costs due to the erosion of designated loans during the parallel period of the previous year to capitalization of financing revenues during the reported period, due to the shift from real depreciation of 8.57% during the parallel period of the previous year to real appreciation of (9.63%) during the reported period.	(351)	(198)	153
Increase in capitalization of interest and other costs on designated loans during the reported period	3	70	67
Total transfer from capitalization of financing costs to capitalization of designated financing revenues.	(348)	(128)	220
Increase in capitalization of non designated financing costs during the reported period as compared with the parallel period of the previous year, which are made up of:			
Shift from capitalization of financing revenues from erosion of non designated loans during the parallel period of the previous year to capitalization of financing costs during the reported period, due to the shift from real appreciation of (-1.11%) during the parallel period of the previous year to real depreciation of 0.8% during the reported period.	85	27	(58)
Increase in capitalization of costs of other interest on non designated loans during the reported period as compared with the parallel period of the previous year.	68	339	271
Total increase of capitalization of non designated financing costs.	153	366	213
Total net decrease of capitalization of financing costs.	**(195)**	**238****	**433****
Total decrease in financing costs for the reported period as compared with the parallel period of the previous year, after transfer to supervised assets and capitalization:	**(68)**	**1,913**	**1,981**

D. Results of operations (cont.)

2. Results of operations for 2005 compared with 2004 (cont.)

i. Financing costs (cont.)

Presented in Financial Statements

		Difference	For the year ended 31/12/2005	31/12/2004
			In NIS millions	
*	Transfer of financing costs to controlled assets		88	2
**	Capitalization of financing costs		(238)	(433)
	Balance of financing costs		2,063	2,412
	Total financing costs		**1,913**	**1,981**

3. Results of Operations according to Sectors for 2006

Below are explanations relating to the results of operations for electricity production, transmission and distribution sectors for the accumulated period, as they are presented in Note 33 to the Financial Statements:

1. Revenue
   1. Generation - net revenue from the sale of electricity in the production sector for the accumulated reported period, in respect of sale of 46,175 million kWh amounted to NIS 13,657 million compared with NIS 12,934 for sale of 44,309 kWh during the parallel period of the previous year, an increase in revenue of NIS 723 million. The increase in revenue stems from two main factors: increase in consumption of 1,866 million kWh, a rate of 4.21%, which means growth of NIS 541 million and an increase of NIS 183 million as a result of real increase in rate of 1.4% in the average revenue per kWh. The increase stems mainly from the increase in fuel prices set off against the decrease in the other rate clauses for the sector.
   2. Transmission - the net revenue from the sale of electricity in the transmission sector for the accumulated reported period amounted to a total of NIS 1,323 million, as compared to NIS 805 million for the parallel period of the previous year (for the kWh quantities which appear in section 1), an increase of revenue of NIS 518 million deriving mainly from the increase of revenue as a result of the changes in rates between the sectors, in accordance with the decision of the Electricity Authority.
   3. Distribution - net revenues from the sale of electricity in the distribution sector during the reported period amounted to NIS 2,503 million as compared with NIS 2,931 million during the parallel period of the previous year. A decrease in revenue of the distribution sector of NIS 428 million that derives mainly from the change in rates between the sectors in accordance with the decision of the Electricity Authority (for kWh quantities which appear in Section 1)
2. Depreciation Costs
   1. Generation - depreciation and amortization costs presented in the Statement of Profit and Loss of the production sector for the accumulated period amounted to the total of NIS 1,547 millions as compared with NIS 1,434 millions for the parallel period of the previous year, an increase of NIS 113 millions.
   2. Transmission - depreciation and amortization costs presented in the Statement of Profit and Loss for the transmission sector for the accumulated period amounted to the total of NIS 543 million as compared with NIS 382 million for the parallel period of the previous year, an increase of NIS 161 million.
   3. Distribution - depreciation and amortization costs presented in the Statement of Profit and Loss of the distribution sector for the accumulated period amounted to the total of NIS 1,054 millions as compared with NIS 1,125 millions for the parallel period of the previous year, a decrease of NIS 71 millions.
3. Fuels

   During the accumulated period, the fuel consumption costs (not including the wage component) for the production sector, amounted to a total of NIS 8,082 million, as compared with NIS 7,833 million for the parallel period of the previous year, an increase of NIS 249 million, deriving mainly from the rise in fuel prices. The cost of fuel consumption is assigned entirely to the production sector.

D. Results of operations (cont.)

3. Results of Operations according to Sectors for 2006 (cont.)

4. Operational costs
   1. Generation - operational costs (not including depreciation, fuels and net pension liability costs) of the production sector for the accumulated period amounted to the total of NIS 1,899 million as compared with NIS 1,689 million for the parallel period of the previous year, an increase of NIS 210 million.
   2. Transmission - operational costs (not including depreciation, fuels and net pension liability costs) of the transmission sector for the accumulated period amounted to the total of NIS 274 million as compared with NIS 189 million for the parallel period of the previous year, an increase of NIS 85 million.
   3. Distribution - operational costs (not including depreciation, fuels and net pension liability costs) of the distribution sector for the accumulated period amounted to a total of NIS 1,357 million as compared with NIS 1,261 million for the parallel period of the previous year, an increase of NIS 96 million.
5. Net pension liabilities costs
   The net cost of pension liabilities for the entire Company, amounted to NIS 117 million for the reported period. The pension costs are assigned to the various sectors according to the current wage ratio of the operational costs in the electricity chain which were, during the reported period, 55.6% for production, 5.5% for transmission and 38.9% for distribution.
6. Financing costs, net
   The net financing costs are divided among the various sectors, primarily according to the ratio of net active fixed assets. The ratio of these assets almost never changes between periods. The financing costs following transfer to controlled assets and after capitalization, for the entire Company, are NIS 2,176 million for the reported period as compared with financing costs in the amount of NIS 1,913 million for the previous year, constituting a growth of NIS 263 million in net financing costs.
   The increased financing costs for the production sector amounted to NIS 118 million, for the transmission sector to NIS 136 million and for the distribution sector to NIS 9 million (see particulars of financing costs in Section D. 1. j).

4. Results of Operations according to reporting units for 2006

Based on Section 33 B of the Government Companies Law and pursuant to the provisions of the Government Companies Authority circulars, as of December 31, 2004 the Company provides disclosures in the form of a note and includes a statement of profit and loss and condensed balance sheet relating to the areas of activities included in the electricity chain's three sectors and to particulars of the assumptions and items used for their assessment (see Note 33 to the Financial Statements).
In analyzing the results of the production sector's operation sites and taking into account the rates set by the Electricity Authority for the sector, we can see that the production sector achieved better results than the rate goals in the amount of NIS 368 million, as a result of additional streamlining, in addition to the streamlining determined in the rate and inter alia from streamlining as a result of the use of a less expensive fuel mix.
The reported units of the transmission and distribution sectors did not achieve the results required for the rate goals in the amount of NIS 53 million and in the amount of NIS 902 million accordingly, due to non coverage in the rate of the general nominal costs in these sectors.

D. Results of operations (cont.)

5. Quarterly Statements of Profit and Loss for 2006

	Adjusted to NIS as at December 2006, in NIS million				
	Quarter 1	**Quarter 2**	**Quarter 3**	**Quarter 4**	**Total**
	(Unaudited)				Audited
Revenues	4,080	3,985	5,198	4,327	17,590
Electricity system operating costs	3,030	3,219	3,746	3,448	13,443
Income from electricity operating system	1,050	766	1,452	879	4,147
Sales and marketing costs	190	185	196	192	763
General and administrative expenses	157	170	202	237	766
Net pension liabilities costs	41	45	18	13	117
	388	400	416	442	1,646
Income from regular operations	662	366	1,036	437	2,501
Financing costs, net	486	499	757	434	2,176
Other (revenues) expenses - net	61	(8)	20	(80)	(7)
Income (loss) from regular operations before income tax	**115**	**(125)**	**259**	**83**	**332**
Costs (revenues) from tax on income	26	(27)	61	28	88
Income (loss) from regular operations after income tax	**89**	**(98)**	**198**	**55**	**244**
Share in earnings of affiliated companies - net	3	2	2	2	9
Net income (loss)	**92**	**(96)**	**200**	**57**	**253**

Differences in operating results between quarters are derived, among others, from:

1. a. The electricity rate changes during the reported year - on January 1, 2006, the electricity rate dropped by 5.86%, most of which stems from the removal of the pension component from the rate. On March 22, 2006, the electricity rate dropped by 1.09%, due to the drop in fuel prices. On September 21 2006, the electricity rate increased by 1.48% due to current rate update and on October 12, 2006 the electricity rate dropped by 3.87% due to a drop in fuel prices.

   b. Seasonality which is affected by the weather - during the winter and summer seasons the average electricity consumption is higher than during the transitional seasons and are characterized by days of record consumption due to extreme cold or heat. The consumer electricity rate which is paid per Time of Use (TOU), which represents about 50% of the consumed kWh, is on average higher during the winter and summer than during the transitional seasons.

   c. The differences in the financing costs between the quarters is caused mainly due to the changes in the various currency exchange rates to which the Company is exposed in its liabilities between quarters, as compared with the changes in the CPI rates for the same quarters. Below are the net results of the erosion of liabilities, for each of the quarters (in NIS million):

For the three months ended on			
31.3.06	**30.6.06**	**30.9.06**	**31.12.06**
(95)	(20)	278	(81)

E. Liquidity for 2006

The surplus cash that was generated from current operations and from receipt of long term loans and other loans and from capital raising by issue of bonds, served mainly to finance the required developments in the electricity sector, in other words, investment in fixed assets in the amount of NIS 3,565 million and settlement of loans in the amount of NIS 3,623 million. During the reported period, the Company presented surplus cash that derived from current activities in the amount of NIS 4,163 million as compared with NIS 3,982 million for the parallel period of the previous year, an increase in the amount of NIS 181 million. The total cash stemming from financing activities reached NIS 454 million and were mainly from recruitment of loans in the amount of NIS 1,223 million and from issue of long term bonds in the amount of NIS 1,964 million, which was off set against settlement of loans in the amount of NIS 3, 623 million.

F. The Company's Internal Auditor

1. Particulars of the Internal Auditor

a. The Company's internal auditor and ombudsman is Dr. Eliyahu Swerdlov.
b. Dr. Swerdlov commenced his service as internal auditor in 1992
c. The internal auditor is not an interested party in the Company, he is not an officeholder in the Company and is not a family member of any of the officeholders, or of the auditing accountants or their representatives.
d. The internal audit annual work schedule for 2007 was approved by the Board of Directors committee on December 21, 2006 and by the Board of Directors on February 1, 2007.
e. The internal auditor does not fulfill any other position in the Company other than that of internal auditor, besides the role of ombudsman. The fulfillment of the additional role, as mentioned above, does not harm the fulfillment of his primary role.
f. The internal auditor is a Company employee. The internal auditor of the Israel Electric Corporation is also the internal auditor of its subsidiary company, Jordan Investments Co. Ltd.
g. The internal auditor does not fulfill any role outside of the Company which creates or could create a conflict of interest with his role as internal auditor.

2. Method of appointment

a. In 1992 the Audit Committee and the Board of Directors approved the appointment of Dr. A. Swerdlov as internal auditor of the Company.
b. The duties, authority and roles imposed on the internal auditor are defined in the internal auditing and ombudsman regulations. The regulations were approved by the Audit Committee of the Board of Directors.

3. The identity of the internal auditor's superior

a. The internal auditor and ombudsman's organizational superiors are the CEO and the Chairperson of the Board of Directors.
b. The identity of the superiors is pursuant to the provisions of Section 148 of the Companies Law and the Government Companies Law.

4. Work schedule

a. The internal auditor's work schedules include a 5-year plan and an annual work program.
b. The annual work schedule is based on the outcome of risk structure analysis and a five year plan (2003-2007) which was approved by the Board of Directors Audit Committee in June 2002. The overall work plan, as far as it can be known in advance, also includes annual auditing tasks required by the Board of Directors and the CEO, and those recommended by the managers of the divisions and departments and approved by the internal auditor.
c. The internal auditor presents a proposed annual work schedule in cooperation with the Chairperson of the Board of Directors and the CEO. The annual work schedule is discussed and approved by the Audit Committee and the Board of Directors.

F. The Company's Internal Auditor (cont.)

4. Work schedule (cont.)

d. The internal audit annual work schedule (2006) includes allocation of time for unplanned tasks of 10% of the planned work days for audit. Every year, the internal auditor presents a 6-month report summarizing the audit reports completed from January to June of the same year. The 6-month report includes the issues that were planned for audit during the current year but where not audited during the current year or the following year. Every year, the internal auditor presents an annual report summarizing the internal audit reports completed during the same year. The 6-month and the annual internal audit reports are presented to the Chairpersons of the Board of Directors and the Board of Directors Audit Committee, to the CEO and members of the Company's management. The main points of the report are presented at the Board of Directors Audit Committee.

5. Audit of the affiliated companies

a. The Israel Electric Corporation's internal auditor is also the internal auditor of the affiliated company, Jordan Investments Co. Ltd. The internal auditor's work schedule includes from time to time, an audit of Jordan Investments Co. Ltd.
b. The National Coal Supply Company has an independent internal auditor, however the internal audit work schedule occasionally includes auditing matters connected to the National Coal Supply Company.

6. Business scope

a. The internal audit department has a standard for 44 employees who are employed in the internal audit and who deal with complaints from the public and from employees.
b. The internal auditor investigates public complaints as well as complaints from employees. In this role and with his authority, the internal auditor also serves as ombudsman. The ombudsman fulfills his role with the assistance of internal audit employees.
c. The scope of the internal audit enables auditing the Company's essential issues once every 5 years.

7. Preparation for audit

a. The audit is prepared in accordance with international professional standards and the professional guidelines of the Institute of Internal Auditors in Israel, pursuant to the laws on the matter and to the Internal Audit Law 5752-1992. The internal auditor manages a staff of professional employees properly trained in the field of internal auditing.
b. During 2007, the internal audit will prepare a risk survey for its purposes and for the 5-year work plan.
c. The Board of Directors estimate that the internal auditor complies with the requirements established in the professional standards.

8. Accessibility to information

The internal auditor and his representatives are given free, consistent and direct access to any document, data, database or information, regular or computerized, including financial data for the purpose of fulfilling their duties. The internal auditor and his representatives are entitled to enter any property and to examine it, pursuant to the provisions of Section 9 of the Internal Audit Law.

9. The internal auditor's report

a. The auditor's reports are presented in writing. Every six months the internal auditor presents a primary audit report and a report monitoring the implementation of decisions and recommendations.
b. During the year, the internal auditor presents final audit reports to the Chairperson of the Board of Directors, the CEO and the Chairperson of the Board Audit Committee. The audit reports are presented to the Board members, members of management and supervising bodies, via the Board secretary.
c. In 2006, the Board of Directors Audit Committee convened 16 meetings to discuss the findings and recommendations of the internal audit on the following dates: February 2, 2006; February 23, 2006; March 16, 2006; April 6, 2006; May 6, 2006; May 18, 2006; June 8, 2006; June 29, 2006; July 20, 2006; August 28, 2006; August 31, 2006; September 28, 2006; October 26, 2006; November 16, 2006; November 23, 2006 and December 21, 2006.

F. The Company's Internal Auditor (cont.)

10. The Board of Director's assessment of the internal auditor's activities

In 2006 Internal Audit presented 123 reports: 98 audit reports and 25 investigation reports. The scope of the internal audit work enables auditing the Company's essential issues once every 5 years. The scope, nature and sequence of the internal auditor's activities and his work schedule are reasonable, in the opinion of the Board of Director's and they fulfill the Company's internal audit duties.

11. Remuneration

The Board of Directors and the CEO determine the status and terms of employment of the internal auditor, according to the recommendation of the Audit Committee. The internal auditor receives the salary and employment terms of a division manager, in accordance with the collective agreement and the decision of the Board of Directors.

In the Board's opinion, this compensation does not affect the professional considerations of the internal auditor.

G. Details concerning the exposure to market risks and their management

1. The individual responsible for the Company's market risk management

The person in charge of the Company's market risk management up until May 31, 2006 was the CFO, Mr. Yossi Dvir (for particulars relating to him see the 2005 periodic report). As of June 1, 2006, the person in charge is the new CFO, Mr. Avner Yehudai.

His particulars are:

a. Date of commencement of service: June 1, 2006
b. Identity No.: 55292007
c. Year of Birth: 1958
d. Nationality: Israeli
e. Position he fulfils in the Company: CFO
f. Positions holds by Mr. Yehudai with the Company's affiliated company or an interested party: Shareholder in the affiliated company.
g. Is he a family member of another senior officer or of an interested party: No
h. Education: Mr. Yehudai is a graduate of the Hebrew University and holds a B.A. degree in economics and accountancy, and he participated in business management studies (without degree) at the Hebrew University in Jerusalem.
i. Employment experience for the past 5 years: Mr. Yehudai is a controlling shareholder in several companies dealing with finance, real estate, and organizational and human resource consultancy.

2. Description of the Company's market risks

The Israel Electric Corporation sells its products, at a price set by an external organization, the Electricity Authority. The price is based on the basic cost principle (as stated in Note 1. a. 3 and as stipulated in Note 3. 1 to the Financial Statements).

Hence, in respect of its primary operation, the Company is not exposed to market risks, with the exception of the following:

(a) <u>Financing</u>

(1) <u>Exchange rate differentials</u>

In order to finance its investments in fixed assets, the Company took loans. The net balance of these loans (after deduction / premium on securities, current maturities, and stock issue and protection transaction costs) as of December 31, 2006 was NIS 40 billion (NIS 19 billion in Israel currency and 21 billion in foreign currency). In order to finance the Company's development plans for 2007 to 2010, the Company requires significant external financing sources.

The rate structure determines that two thirds of the Company's active assets, recognized by the Electricity Authority, should be financed by foreign capital while 54% (as of December 31, 2006) should be in foreign currency, according to the composition of the Bank of Israel currency basket, and for this structure and composition the Company has rate coverage (see Note 3 to the Financial Statements) For the balance of its foreign currency loans, the Company is exposed as follows:

G. Details concerning the exposure to market risks and their management (cont.)

2. Description of the Company's market risks (cont.)

(a) Financing (cont.)

(1) Exchange rate differentials (cont.)

1. Exposure to the difference between the actual liability (about 34.5% nominal and foreign currency linked) compared with the liability recognized in the rate.
2. Exposure to the difference between the weight of the foreign currency to which the Company's loans are linked, compared with the weight of the currencies that comprise the Bank of Israel basket.

(2) Interest on all the Company's loans

The Company is exposed to the difference between the interest recognized (in foreign currency and in NIS) in the base rate, which varies only at the time of the annual rate update, and the actual market interest rate (for foreign currency and NIS) for its loans.

(b) Changes in the prices of input

The input basket of the other rate components (with the exception of fuel costs) determines, together with the CPI changes, the consumer price. From this, the Company is exposed to market risks which derive from a real rise in the prices of the other expenses.

(c) Changes in the capital market in which the pension liability funds are invested

The Company is exposed to yield to maturity of government bonds in which the Company's pension liability funds are invested, including the aspects of its investment value and the capital rate for calculating the pension liabilities.

3. The Company's market risk management policies

(a) The Company's market risk management policies

With the intention of minimizing the Company's exposure to foreign currency fluctuations, the Board of Directors decided in respect of the Company's exposure, as follows:

1. The real amount of the exposure for linked and nominal liabilities in foreign currency which were transferred to the electricity consumers - the Company carried out protection transactions (mainly Swap and Forward transactions) in foreign currency in order to adjust the cost structure to the recognized income structure (composition of the Bank of Israel currency basket). The Swap transactions were made for a minimum of two years while taking into account the interest rate differences between the various currencies with the permitted option of exposure of up to 15% of the loan balance in the same currency.
2. In respect of the exposure of the Company's other liabilities in foreign currency (after implementation of Section 1 above), the Company will exchange foreign currency liabilities for CPI linked liabilities by carrying out CPI - foreign currency protection transactions (mainly Swap and Forward transactions) and if the market conditions justify it, foreign currency-NIS transactions in order to minimize foreign currency exposure.
   The Swap transactions will be carried out for a minimum of two years while taking into account inflation in Israel and in Western countries and the interest rates on the capital markets.
   In general, transactions will be carried out to cover at least 85% of the exposed balance, so that the amount exposed in any currency will not exceed the accrued value of 15% of the loan balance in the same currency.
3. In order to allow dynamic implementation of the policies as mentioned in Section 2 above, and in order to prevent random technical deviations, the CFO estimates that the amount of exposure for each currency, both for the defined amount and for the exposed balance should not be higher or lower than 5% of the loan balance in the same currency, with the addition of 2% of the loan balance for each 1% interest difference if it is harmful for the Company's liabilities.
4. Deviation of more than 15% will be permitted if the deviating amount does not exceed US$ 10 million or the equivalent value in another foreign currency, for each currency separately.
5. Additional transactions such as IRS options for currencies and interest rates will be carried out if the market conditions indicate that they are worthwhile/minimize risk.

G. Details concerning the exposure to market risks and their management (cont.)

3. The Company's market risk management policies (cont.)

(b) Division of responsibility and scope of authority of the Company's management

According to the Company's policies on the matter of dealing with exposure deriving from market risks as stipulated above, it has been decided that the Finance Division manager be authorized to approve transactions, with the exception of additional transactions which require the approval of the CFO (see Section 3 (a) 5 above). Furthermore, the Board of Directors decided that specific Company employees should carry out, on behalf of the Company, Swap transactions in accordance with its policies.

A detailed report will be presented to the Board of Directors every quarter, at the time of the discussion on the financial statements, in respect of the protection transactions carried out during the current quarter.

4. Supervision of risk management policies and their implementation

(a) The Board of Directors actions in practice

As mentioned above, the Board of Directors receives quarterly reports relating to the Company's risk management policies and exposure to market risks.

(b) The Company's supervision mechanisms

The Company's internal auditing department monitors implementation of the decisions of the Board of Directors and its Committees.

(c) Losses derived from market risks

During the reported period the Company incurred losses of NIS 909 million in respect of currency exchange transactions and a loss of NIS 14 million in respect of interest exchange transactions.

Furthermore, the Company incurred losses in respect of forward transactions in the amount of NIS 302 million.

The role of the defense transactions is to hedge the Company's exposure to foreign currency and their reverse outcome to the outcome of the base asset exposure - the Company's foreign currency liabilities. Therefore, we should mention that the above losses in the amount of NIS 1,225 million have been fully off set by the earnings, in a similar amount, stemming from the erosion of the loans for which these transactions were carried out (see Section 9 below).

5. Additional details relating to the financial market risk management pursuant to the Government Companies Authority circular

Pursuant to the Government Companies Authority circular of January 2005, government companies are required to specify as follows:

1. The Company manages a periodic system for financial market risk management by means of monthly monitoring of its financial liabilities and their protection.
2. During the reported period the Company monitored its liabilities and carried out protection as required and in accordance with the policies it established, following consultation and after obtaining independent opinions from external experts.
3. The loss risks in the various investments and the Company's liabilities resulting from the possibility that the second party to the transaction or to the Company's liabilities may not comply with their undertakings or lack the option to legally enforce the debt, are similar to the balances of these assets in the Company's balance sheet.
4. The Company has no market risks in external balance sheet positions, since these transactions were carried out for the purpose of protection only.

   As a rule, the Company lawfully operates in the matter of finances and investments in order to minimize costs and to maximize yield, while dispersing its investments among various banks. The Company's internal audit generally examines these actions according to patterns, methods and auditing programs approved by the Board of Director's Audit Committee (also see Note 23 to the Financial Statements).

6. Linkage based report

For information concerning the linkage of the Company's financial balances as at December 2006 and for the previous year, see table in Note 23 to the Financial Statements.

G. Details concerning the exposure to market risks and their management (cont.)

7. Sensitivity analysis

Sensitivity analysis to changes according to market factors:

a. Market factors Fair interest

	Income from market factor increases		Fair value	Loss from market factor decreases	
	+10%	+5%		-5%	-10%
			In NIS millions		
Long term fixed interest loans	(289)	(145)	9,404	152	308
Long term variable interest loans	-	-	6,348	-	-
Negotiable securities	-	-	7,287	-	-
Non negotiable securities	(701)	(357)	20,878	371	759
SWAP - protection transactions	(28)	(11)	1,194	14	31
FORWARD - protection transactions	-	-	98	-	-

b. Market factors Foreign currency exchange rates

	Loss (income) from market factor increase		Fair value	Loss (income) from market factor decrease	
	+10%	+5%		-5%	-10%
			In NIS millions		
Loans and securities according to currency					
NIS	-	-	15,503	-	-
US Dollar	2,065	1,032	20,643	(1,032)	(2,065)
Euro	511	255	4,926	(255)	(511)
Japanese Yen	271	136	2,712	(136)	(271)
Pound Sterling	4	2	34	(2)	(4)
Swiss Francs	8	5	99	(5)	(8)
SWAP - protection transactions					
NIS	-	-	6,612	-	-
US Dollar	(688)	(345)	(6,880)	345	688
Euro	66	33	658	(33)	(66)
Pound Sterling	90	45	899	(45)	(90)
Swiss Francs	(10)	(5)	(95)	5	10
FORWARD - protection transactions					
NIS	-	-	3,523	-	-
US Dollar	(57)	(29)	(574)	29	57
Euro	(99)	(50)	(994)	50	99
Japanese Yen	(170)	(85)	(1,699)	85	170
Pound Sterling	(16)	(8)	(158)	8	16

The Company is not exposed to CPI for its exclusion from Standard No. 12 (see Note 3. b. 9. to the Financial Statements)

Part of the costs for long term liabilities are capitalized to fixed assets (see Note 28 to the Financial Statements Part of the costs for exposure to foreign currency or foreign currency linkage is covered in the current electricity rate (see Note 3. a. 2. to the Financial Statements),

G. Details concerning the exposure to market risks and their management (cont.)

8. **Contracts and commitments**

The Company has contracts and strong commitments to execute contracts with foreign currency suppliers in an amount of NIS 1,786 million. These contracts are for the purchase of equipment and services and for the construction of facilities, and are mainly in US Dollar and Euro.

The Company is not exposed to losses in respect of the purchase of fuels because of the coverage given to these costs within the framework of the electricity rate. Similarly, the Company anticipates that changes in the prices of equipment that derive from changes in currency exchange rates will be recognized in future rates (also see Note 21 to the Financial Statements).

9. **Derivative position**

In accordance with the Company's policies as set forth in Sections 2 and 3 above, the Company signed foreign currency exchange transactions, which are protection transactions (see Section 4. g. above) and their balances as of December 31, 2006 are as follows:

- Purchase of US$ 305 million in exchange for Euro 290.5 million for a period of 7 years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 398 million.
- Purchase of US$ 240 million in exchange for Pound Sterling 165 million for a period of 5 years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 345 million.
- Purchase of US$ 1,300 million in exchange for NIS 4,935 million for a period of 10 years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 199 million.
- Purchase of Euro 120 million in exchange for NIS 693 million for a period of up to two years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 33 million.
- Purchase of Pound Sterling 56 million in exchange for NIS 460 million for a period of up to two years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 5 million.
- Purchase of Swiss Franc 28 million in exchange for NIS 100 million for a period of up to two years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 4 million.
- Purchase of Euro 47 million in exchange for US$ 60 million for a period of 7 years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 10 million.
- Purchase of US$ 400 million in exchange for NIS 1,852.4 million for a period of 25 years
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 199 million.

Finally, the Company used Forward transactions, and their balances as of December 31, 2006 were:

- Purchase of US$ 748 million in exchange for NIS 3,206 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 52 million.
- Purchase of Euro 203 million in exchange for NIS 1,115 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 25 million.
- Purchase of Japanese Yen 11,885 million in exchange for NIS 488 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 55 million.
- Purchase of Japanese Yen 2,912 million in exchange for Euro 20 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 5 million.
- Purchase of Japanese Yen 20 million in exchange for NIS 163 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 2 million.
- Purchase of Japanese Yen 33,120 million in exchange for US$ 300 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 74 million.
- Purchase of NIS 1,327 million in exchange for US$ 300 million for a period of up to one year.
  The net fair value as at December 31, 2006 is a liability in the amount of NIS 61 million.

The transactions in financial instruments are carried out with banks and in the Company's opinion it does not anticipate losses deriving from credit risks in respect of them. The balance of the transactions as of the balance sheet date is the higher balance. The Company does not hold or sell commercial financial instruments.
As of December 31, 2006 the company has no interest exchange transactions.

H. Directors with accounting and financial expertise

Pursuant to the Securities (Periodic and Immediate Reports) Regulations, 1970 of the Securities Law, 1968, concerning reporting in respect of directors who have accounting and financial expertise, the Board of Directors decided that the minimum number of directors with accounting and financial qualifications is three, while taking into consideration, among others, the growth of the Company and its nature, the complexity of its operations and the number of Board members. In the opinion of the Board of Directors, this number will allow the Company's Board to comply with the obligations imposed on it as part of the new directive and this includes the obligations imposed on it in accordance with the law and the Company's articles of association, and especially in respect of its responsibility to examine the Company's financial state and to prepare and approve the financial statements.
These Directors are integrated into the following Board of Directors committees which deal with the accounting and financial matters:
Planning and Budget committee; Finance and Stock Issue committee; Executive Committee; Audit committee, Property and Construction committee, Human Resources Organization and Procedures committee, Communications, Marketing and Customer Services committee, and Investment and Risk Management committee.
At the time of signing this report, nine directors with accounting and financial qualifications serve on the Company's Board of Directors. Their particulars, including the facts that make them worthy of serving as directors, as mentioned above, and the details of the committees on which they serve, are as follows:

Mr. Mordechai Friedman - Certified Public Accountant since 1979 (Chairman of the Board of Directors), has a B.A. in Economics and Accounting from the Tel Aviv University. Mr. Friedman was a managing partner of the Deloitte Brightman Almagor consulting group and since 2005 serves as Deputy Chairperson and CEO of this group. Mr. Friedman currently serves as a member of the Board of Directors of the Blue and White Compan. and Inbal Insurance Company. Public office held in the past and at present by Mr. Friedman .includes:: Member of the Board of the Israeli Securities Authority (1983-1995), Chairperson of the Institute of Certified Public Accountants and member of various committees of the Institute of Certified Public Accountants (since 1992), former member of the Antitrust Tribunal and he serves as a permanent observer at the Accounting Standards Board (since 1997).

Mr. Shaul Zemach - holds a B.A. degree in Economics and International Relations from the Hebrew University and a M.A. in Public Policy from the Tel Aviv University. He served as coordinator of the energy and housing of the budget division. Mr. Zemach currently serves as the deputy head of the Budget Division at the Ministry of Finance and coordinates the handling of the Ministries of Transport, Interior, Environment and Agriculture. He serves as a member on the Finance and Stock Issue Committee and the Investment and Risk Management Committee.

Mr. Israel (Izzy) Tapoohi - is a Certified Public Accountant. He graduated from the University of Melbourne in Economics, Business Management and Accounting. He is a CPA in Australia and in Israel. Until immigrating to Israel, Mr. Tapoohi served for several years as the Treasurer of the Dutch Group, Philips, in Australia. In Israel, he served, among others, as an employee at the Liuboshitz, Casirer & Co. Certified Public Accountants. He served as former Chairperson of the Board of Directors of Bezeq Israel Telecommunications Corporation Ltd. and as Chairperson of the Board of Directors of Africa-Israel Investments Ltd. Mr. Tapoohi currently serves as CEO of InQsoft and as a member of the Board of Directors for several additional companies. In the past he served on the Bank of Israel advisory council and committee. He currently serves as Chairperson of the Audit Committee for Strauss-Elite Ltd., and as a Board member of Harel Investment Insurance Ltd, Paz Petroleum Company Ltd., and other companies. He serves as on the following Board of Directors committees: as Chairperson of the Human Resources Organization and Procedures Committee, and as a member of the Executive Committee, the Planning and Budget, Finance and Stock Issue and Communication, Marketing and Customer Service Committees.

Mr. Yigal Cohen-Orgad - holds a B.A. in Economics and Education from the Hebrew University in Jerusalem and participated in M.A. studies in Economics and Business Management at the Hebrew University in Jerusalem. Mr. Cohen-Orgad served in the past as Minister of Finance of the State of Israel. He deals in project management in the construction industry and served as substitute Chairperson of the Bank Leumi Board of Directors. He served and currently serves as a member of the Audit and Finance committees of large public companies, including Bezeq. where Mr. Cohen-Orgad serves as external director. He serves as a member of the following Board of Directors committees: Planning, Budget and Computer, Audit, Finance and Stock Issue and Regulatory committees.

H. Directors with accounting and financial expertise (cont.)

Mr. Michael Lazar - is a Certified Public Accountant, Graduate of Hebrew University (Tel Aviv Branch) in Accountancy. He is a partner in Strauss - Lazar & Co. Certified Public Accountants. Mr. Lazar has worked as a CPA since 1972, mainly in tax consulting and he advises companies in Israel and abroad. He is a member of the following Board of Directors committees: as Chairperson of the Finance and Stock Issue Committee, and as a member of the Executive Committee, the Property and Construction, Human Resource Organization and Regulations, and Insurance, Legal Advisors and Accountants Committees.

Ms. Rochelle Don-Yechiya - is an attorney at law and arbitrator. She manages an independent law office and specializes in commercial and labor law and in negotiation. Ms. Don-Yechiya is a B.A. graduate in Linguistics, Economy and Social Sciences, and holds a Masters (LLM) degree in Law from the Tel Aviv University. She serves as on the following Board of Directors committees: as Chairperson of the Property and Construction Committee and as a member of the Financial and Stock Issue, Human Resources Organization and Regulations, Executive Committee, Audit and Regulatory Committees.

Mr. Arieh Rozenberg - holds a B.A. in Economics and Accounting from the Bar Ilan University and has been a certified public accountant since 1985. Mr. Rozenberg works at the office of Amos Kopolowitz Certified Public Accountants and his expertise is taxation. He serves as a member on the following Board of Directors committees: Planning, Budget and Computer, Insurance, Legal Advisors and Accountants, Finance and Stock Issue, Executive Committee, Property and Construction and Investment and Risk Management Committees.

Mr. Oded Koritshoner - is a graduate of the Hebrew University in Jerusalem. He holds a B.A. in Economics and a M.A. in Business Administration. Mr. Koritshoner served as CFO of Telrad Holdings Ltd. He currently serves as director for the following companies: Priority Investments Ltd (Chairperson), Priority Property Management Ltd. (Chairperson), Excellence Coffee (Chairperson), and Skylife Israel Ltd. Mr. Koritshoner is a member of the Finance and Stock Issue, Property and Construction, Audit, and Quality of the Environment Committees and is Chairperson of the Investments and Risk Management Committee.

Mr. Moshe Gavish (External Director) - holds B.A degrees in Law and Economics and a MBA from the Hebrew University in Jerusalem. He serves as company manager, and financial, legal and strategic consultant. Mr. Gavish serves as chairperson of the Executive Committee of the University of Haifa and on the Board of Directors of the following companies: Industrial Development Bank of Israel, Allium Ltd., Afikim Investments Ltd., and Medipower Ltd. He served in the past as Income Tax Commissioner and CEO of Mercantile Discount Bank. He serves as a member on the following Board of Directors committees: Finance and Stock Issue, Audit, Planning and Budget, and Executive Committees, and as Chairperson of the Regulatory and Investments and Risk Management Committees.

I. Critical Accounting Estimates

Information pertaining to critical accounting estimates pursuant to the regulations of the Securities Authority, in accordance with clause 36 a. of the Securities Law 5728-1969 are presented below:
Critical accounting estimate - an accounting estimate that complies with the following conditions:

a. When selecting it, the company was required to make assumptions relating to the circumstances and/or events that involve significant uncertainty.

I. Critical Accounting Estimates (cont.)

b. Use of an alternative estimate which could have reasonably been chosen or a reasonable change that could apply to an estimate that the company chose from one period to another, which have a significant impact on presentation of the company's financial state or the results of its operations.
The critical estimates that were applied in the financial reports are described below:
1. Actuarial estimates for the company employers and pensioners: In order to estimate the pension liabilities for the company's employees and pensioners, the company relies on actuarial estimates by an outside actuary and conventional estimates of an actuarial examiner. The actuarial liability estimate is based on the anticipated future cash flow, in accordance with the conventional actuary assumption system. In effect, for better or for worse, these cash flows are likely to be different from what is expected due to possible difference between the actual future reality and the forecasts. The system of assumptions on which the actuarial balance sheet is based is also subject to changes that are likely to occur to it in the future, such that - with the accumulation of updated information in respect to factors that have an effect on the continued force of these assumptions. For example: changes in the development of life expectancy, regulatory changes, economic changes, and more. Such possible changes will (when they occur) affect the amount of liability.
The following are the main estimates according to which the actuarial liability is calculated:
a. The liability is calculated on the basis of the life table published by the capital market division of the Ministry of Finance, which includes adjustments for the company's employees and pensioners. This is based on a comprehensive study carried out in the company, which includes future dynamic improvement in life expectancy, following the interim results of a study that was made, according to which the rate of increase in lifespan is greater than what was assumed in previous calculations.
b. The liability was calculated according to the real forecasted rates of increase that were calculated as of this report, based on the total increase in wage calculated for pension. This includes both the personal and the general increase, and an average of 2% per year in the pension for a pensioner or survivor of a pensioner (see details below).
c. The liability is calculated according to the compulsory retirement age of 67 for men and women and in accordance with the actuarial guidelines for retirement prior to the above ages (such as disability, early retirement and death).

Changes in actuarial assumptions in the past three years

Changes in 2004

Clause	New assumptions	Old assumptions
Mortality table	According to the Ministry of Finance table as published on October 17, 2004	According to the Ministry of Finance pension circular, January 2000
Forecasted real rate of increase in salary for active employees	Use of a personal salary scale according to Ministry of Finance circular of January 2000 with an additional general increase in salary of 1% only.	3% permanent

Reason for changes

a. The liability is calculated on the basis of the life table published by the capital market division of the Ministry of Finance, which includes future dynamic improvement in life expectancy, following the interim results of a study that was made, according to which the rate of increase in lifespan is greater than what was assumed in previous calculations.
b. The liability is calculated according to the forecasted increase in wage after implementation of the recommendations of the capital market division and the company's outside actuary. The rates of increase will be calculated according to a personal wage scale and estimation of a general increase in wage of 1% more than the increase in the personal wage scale, a rate that reflects the company's future wage policy.

I. Critical Accounting Estimates (cont.)

Changes in actuarial assumptions in the past three years (cont.)

Changes in June 2005

Clause	New assumptions	Old assumptions
Death of active employees	60% of Table 1 A in the Ministry of Finance circular of 2000	According to Table 1 A 5 of the Ministry of Finance circular of February 2000
Death of pensioners	90% of Table 1 A 4 in the Ministry of Finance circular of 2000	According to Table 1 A 5 of the Ministry of Finance circular of February 2000
Future improvements in mortality rates	According to the rates in Table 12 in the position paper of the chief actuary of April 20, 2005.	According to the rates specified in the letter of the chief actuary to the Ministry of Finance dated October 17, 2004
Retirement rates for early retirement	Retirement rates for early retirement for accounting purposes based on 40 retirees a year	Early retirement rates based on the company's experience in 1987-1999 and their adaptation to company policy (50% of the rates)
Rates of leaving	Based on the company's experience in 1997-2004	Based on the company's experience in 1987-1999

a. The actuarial changes in respect of death of active employees and pensioners, the rate of leaving and the future improvements in the mortality rate, were based on the results of a study that was made in the company to determine updated deduction tables suitable for calculating actuarial liabilities to the company's employees. An adjustment was made in the deduction table in respect of death of employees and pensioners, as in the circular published by the capital market division of the Ministry of Finance on February 29, 2000 (see Appendixes B and E of the actuarial opinion). Future improvements in the mortality rate are based on the rates in Table 12 of the opinion of the chief actuary of the Ministry of Finance published on April 20, 2005.

b. Early retirement rates: The company's experience in recent years indicates a rate of early retirement that is higher than the rates that were assumed in previous actuarial calculations. At the same time, the outside actuary received a letter from the company's CEO determining that "the number of employees retiring in the regular early retirement framework will not exceed 40 retirees per year. Any other retirements and special retirements will only be carried out on the background of structural changes with board approval". The content of the letter submitted to the outside actuary was also approved by the board of directors. Furthermore, pursuant to the professional opinion of the company's outside accountant, based on the accounting regulations, provisions will not be made for early retirement deriving from structural change due to expectations only.

Reasons for changes

In light of the above, retirement rates for early retirement for accounting purposes were based on 40 retirees a year. The outside actuary determined early retirement rates adjusted to an average of 40 retirees per year, in the next three years. Due to the distribution of ages of the company's employees and the ageing of the population, after three years the rates defined by the outside actuary will increase the number of retirees to over 40 retirees per year.

The distribution of the ages of retirees was adapted to the company's experience in recent years.

The influence of changes in the above assumptions is expressed in the increase of the actuarial liabilities of NIS 258 million (mainly due to the change in the mortality table)

I. Critical Accounting Estimates (cont.)

Changes in actuarial assumptions in the past three years (cont.)

Changes in December 2006

Clause	New assumptions	Old assumptions
Forecasted real rate of increase in salary for active employees	Use of the wage scale based on total increase in wage	Use of personal wage scale according to Ministry of Finance circular of January 2000 with an additional general increase in wage of only 1%.

Reason for changes

Liability is calculated on the basis of the forecasted real increase in wage, based on a study made by the Company's actuary, using the Company's data of the past 15 years. The study's findings led the Company's actuary to the conclusion that the salary growth model, based on personal growth accompanied by general growth, is not appropriate for the Company. The actuary believes the salary growth graph should be determined according to the total salary growth, including both personal and general growth. The chief actuary of the capital market division submitted written notification to the CEO of the company managing the central pension fund for the Company's employees and pensioners (Hereinafter: Clal) on December 21, 2000, that in response to his request, he does not object that Clal's actuary balance sheet of 2006 will be based on the assumed real increase in the pension wage proposed in the letter of the Company's actuary. This reassessment led to an increase in the actuarial liability as of December 31, 2006, totaling NIS 35 million.

The capital market, insurance and savings division of the Ministry of Finance published a draft circular on January 4, 2007 addressing actuarial balance sheet calculation method and preliminary pension fund regulations. If the draft circular is implemented, it is estimated that the affect of its assumptions on the Company's actuarial liabilities as of December 31, 2006, which mainly relate to change in the mortality table, amounts to NIS 214 million.

Sensitivity analysis to changes according to key estimation factors:

Actuarial assumption	Increase in Change	NIS millions	Change	Decrease in NIS millions
Capitalization interest rates	-0.1%	328.4	+0.1%	319.5
Rate of salary increase	+0.5%	576.2	-0.5%	532.2
Rate of pension increase for pensioners	+0.5%	1,042.8	-0.5%	950.9

2. In Israel, special accounting principles regarding companies of this nature have not yet been determined and, accordingly, the Company applies the standard of the Financial Accounting Standards Board in the US, Standard No. 71 (hereinafter: the Standard), which deals with accounting implications of certain types of regulation supervision. One of the conditions for implementation of the Standard determines that the regulated rates are designed to recover the specific costs (including the required return on capital) of providing the regulated services or product. The Standard requires that regulated companies reassess the probability of recovering their regulatory assets at each balance sheet date.

The company's rates are based on the decision of the public regulating organization - the Electricity Authority.

The implication of the Standard is that the Company may capitalize costs that would otherwise be recorded as expenses, since two conditions exist:

1. It is probable that future revenues, which will not be lower than the capitalized costs, will be generated from the inclusion of these costs in the costs recognized for the purposes of the rate.
2. Based on the available evidence, the future revenues will be given to the Company to cover all the accrued expenses and not to maintain a similar level of expenses. If the revenue is given by automatic update of the rates, the condition would be that the supervisor would clearly intend permitting coverage of the expenses accrued in the past.

   Should SFAS 71 no longer be applicable on the Company, there would be grounds to eliminate the controlled assets (and not to create controlled assets in the future) and to examine making provision for a drop in the value of other assets in accordance with the regulations established in Standard No. 15 (Also see Note 3.c.2 to the Financial Statements).

I. Critical Accounting Estimates (cont.)

Changes in actuarial assumptions in the past three years (cont.)

3. Pending claims - in principle, including class action. The Company's assessment is based on the exposure estimates and opinions of the legal and professional advisors, which are prepared for each financial report. The maximum amount that the Company was exposed to, in excess of the provisions it made, was NIS 10,404 million. The amount of this exposure does not include exposure due to uninsured claims for bodily harm and which are not fixed with an amount.

J. Peer Review

On July 28, 2005 the Securities Authority published guidelines pursuant to Section 36a(b) of the Securities Law 1968, obligating disclosure relating to agreement to conduct peer review.

This procedure is intended to ensure the quality of the auditing accountant's work and to strengthen the confidence of the capital market and turn it into a sophisticated and trustworthy capital market. The Israel Institute of Certified Public Accountants recently instituted peer review with the aim of promoting the supervision of the practices of certified public accountant firms and examining the use of the required regulations during the audits carried out by each firm.

Despite the lack of a solution for the legal issues raised by the Company, the Electric Corporation Board of Directors decided, due to the importance of peer review, to approve the Company's participation in a peer review, subject to the auditing and reviewing accountants signing the Letter of Undertaking which appears on the website of the Institute of Certified Public Accountant in Israel.

K. Auditing Accountant Fee

Pursuant to Section 36 A (b) of the Securities Law, 5728-1968, below are particulars of the overall fee that the Company's auditing accountant is entitled to receive for his auditing services and for other services in connection with 2005 and 2006.

		For the year ended December 31	
		2006	**2005**
		NIS thousands	
A.	Auditing service fee, for services connected to the audit and for tax services	1,255	1,314
B.	Additional fee - the overall fee is for services rendered by the auditing accountant which are not included in Section A above.	733	224

<u>Particulars of the types of services included in the amounts in Section B</u>

1. Support the Company prepare for adopting the international accounting standards
2. Carry out special analysis, in accordance with the guidelines of the Government Companies Authority
3. Prepare professional opinion according to the requirements of the State's authorities and/or on accounting and other subjects.
4. Support the Company in internal discussions opposite external entities.
5. Issue of various certifications.

L. Fixed assets in the Gaza Strip

The Company filed a claim for compensation from the Disengagement Authority for its fixed assets that remained in the Gaza Strip following the disengagement, pursuant to the Disengagement Plan Implementation Law 5765-2005. As of the date of the signing of this report, no response has as yet been received in respect of this claim. In the Company's estimate, the compensation, when it is received, will not be less than the book value of the assets.

M. Evaluation of the effectiveness of internal audit and disclosure on the financial statements

Pursuant to the directives of the Securities Authority and based on the principles of Section 404 of the Sarbanes-Oxley Act in the United States, the Company was required to prepare reports relating to the Company's control over all matters connected to the actuary assumption for the purpose of the calculation of its pension liabilities and for all matters connected to fixed assets and fixed assets under construction.

The report on the matter of the actuary assumptions for the purpose of the calculation of pension liabilities was completed, presented to the Securities Authority and published publicly. The report included mapping audits and their effectiveness, including their weaknesses and strengths. The conclusions of the report, following examination of the effectiveness of the Company's main audits throughout the calculation and presentation of the pension position in the financial statements, were that the audits relating to the examination of the actuary calculations and record of the pension liabilities were carried out and documented fully. Furthermore, based on the conclusions of the report, working procedures between all the entities within the Company were prepared in respect of the procedures involved in calculating, recording and presenting the actuary liabilities.

The report relating to the Company's audit concerning all matters connected to the fixed assets and fixed assets under construction is currently being prepared and should be completed by the end of April 2007. This report will include mapping of all the written and IT audits and examination of the effectiveness of the audits, including their weaknesses and strengths, and will also include recommendations for improving the flaws uncovered in the audits, should any be found.

Upon completion of the report, it will be sent to the Securities Authority and its main points will be published publicly.

Pursuant to the directives of the Government Companies Authority which were published in regulations, Government companies, among them the Company, are obligated to attach to their annual and quarterly financial statements another report relating to the actions taken and the presentations given for the purpose of the proper protection of the financial statements and the Board of Directors report. In preparation for implementing the provisions which are applicable as of the current financial statements, the Company established a system for ensuring and evaluating the effectiveness of the procedures, disclosure control, data collection procedures and evaluation of information for the purpose of financial reporting. This is in order to enable the officeholders signed on the financial statements and the Board of Directors report to sign a declaration in the additional report, that the financial statements and the Board of Directors report do not contain incorrect representation of the basic facts and that they properly reflect, from all essential aspects, the Company's current financial state, outcome of operations, and equity and cash flow changes and for the periods represented in the reports.

N. The Company's preparation for adopting International Financial Reporting Standards (IFRS)

1. Adopting IFRS

In July 2006, the Israel Accounting Standards Board published Accounting Standard No. 29 - Adoption of International Financial Reporting Standards (IFRS) (see Note 2 to the Financial Statements).

<u>Company's preparation for adopting IFRS</u>

1.1 The Company defined the adoption of the IFRS as a top priority project and found that identifying the differences between the IFRS and the generally accepted accounting principles in Israel require substantial time and resources. Therefore, the preparation included the appointment of a senior department manager to head the project and the appointment of a team, to be headed by a project manager, which meets once a week to discuss and report on the progress of the project; the establishment of a steering committee headed by the Accounts and Finance Division manager, which meets once every two weeks and receives updates on the project; ongoing reports to the CFO and CEO and monthly reports to the Board of Directors.

N. The Company's preparation for adopting International Financial Reporting Standards (IFRS) (cont.)

1. **Adopting IFRS (cont.)**

   Company's preparation for adopting IFRS (cont.)

   1.2 In general the adoption of IFRS project was divided into three stages:

   a. Mapping and identification of the differences between the generally accepted accounting principles that the Company implements and the principles of the IFRS.

   b. Identification of the required changes in the business procedures and working methods, analysis and finding solutions, analyzing the various methods of dealing with the options of the IFRS and implementing the solutions, including the changes required in the information system, formulating regulations and so on.

   c. Implementing the changes, preparing an Opening Balance Sheet as of the transition date (January 1, 2007) and reorganizing the 2007 financial statements on the quarterly level.

2. **Mapping and identifying differences between the generally accepted accounting principles and the IFRS**

   At this stage, which was, as mentioned above, defined as Stage A of the adoption of IFRS, all the international standards were reviewed and the differences between them and the accounting policies taken by the Company were analyzed. The team arrived at the conclusion that there were five international standards which could have significant effect on the Company, and they are:

   1. IAS 16 - Fixed assets
   2. IAS 19 - Employee benefits
   3. IAS 23 - Capitalization of credit costs
   4. IAS 39 - Recognition and measurement of financial instruments
   5. IFRS 1- First-time adoption and exemptions for transition date.

   As of the signing of this report, Stage A of the IFRS adoption has been completed.

3. **Identified differences and alternative options in respect of the five international standards mentioned in Section 2 above:**

   3.1 IAS 16 - Fixed assets

   Reduced historical costs pursuant to IFRS, with historical calculations

   This calculation is based on dividing each asset into components (a broader breakdown than the current method) is similar to Israeli Accounting Standard No. 27, which becomes effective as of January 1, 2007, and determines the lifespan and depreciation for each component separately. According to the advice of external consultants the Company divides its fixed assets into basic components and fixes lifespan and depreciation for each component separately, while comparing with the accepted norms in the Electric Corporation's world. For the purpose of implementing this alternative with the international standard, the Company is required to recalculate the costs for each component (historically), while taking into account other international standards, including recalculation of wage costs which were recorded as part of the fixed asset in accordance with IAS 19, and financing costs which were capitalized to the fixed asset in accordance with IAS 23.

   Furthermore, we should mention that according to the decision of the Israel Accounting Standards Board, January 1, 2004 was fixed as the date on which the Financial Statements would cease being adjusted to inflation, pursuant to the international standard. Up until December 31, 2007, the Company prepares its financial statements (see Note 3.b 9.c to the Financial Statements) when they are adjusted to the CPI pursuant to the Government Companies Law, however, under the IFRS rules, the Company should cease adjusting its Financial Statements as of January 1, 2004 retroactively. The Company cannot at this stage estimate the net affect of cancellation of the adjustment of its fixed assets from this date, until December 31, 2006, on the calculation of its wage and financing costs which should historically be capitalized to the fixed assets and of the calculation of depreciation according to the components method.

N. The Company's preparation for adopting International Financial Reporting Standards (IFRS) (cont.)

3. Identified differences and alternative options in respect of the five international standards mentioned in Section 2 above: (cont.)

3.1 IAS 16 - Fixed assets (cont.)

Alternative method for calculating the fixed asset costs as of the transition date.

According to the provisions of IFRS 1, the Company may choose to replace the historical calculation with the alternative of assessing the Company's assets according to market value as of the transition date, which the Company intends implementing via external global electricity market assessors.

According to the provisions of the international standard, the Company is entitled to choose each of the alternatives for each of its asset groups.

The Company decided to examine both alternatives simultaneously.

3.2 IAS 19 - Employee benefits

For the transition date, the Company may choose one of the following two alternatives:

a. Recalculation of the historical wage costs, in other words, to recalculate the pension liabilities and the other wage components in accordance with IAS 19, to find or historically reconstruct the data in order to apply the standard is most complicated and most difficult to implement.
b. IFRS 1 allows companies adopting the international standards for the first time to choose exemptions to ease the implementation of IAS 19 and to calculate for the first time, the employee liabilities only for the transition date.

The Company appealed to the actuaries to calculate the wage costs retroactively.

3.3 IAS 23 - Capitalization of credit costs

Pursuant to this standard, the amount of the credit costs due to exchange rate differentials eligible for capitalization to fixed assets under construction for the Company's foreign currency liabilities, are limited. The Company has prepared to calculate and measure its capitalizable exchange rate differentials through its information system. Furthermore, after determining the cost of fixed assets under construction in accordance with IAS 16, the credit capitalization costs shall be calculated retroactively.

3.4 IAS 39 - Recognition and measurement of financial instruments

The objective of this standard is to fix principles for identifying, diminishing and measuring of financial instruments. The basic central issue of this standard, which requires modification of the accounting treatment in the Company's books, is financial derivatives. All the financial derivatives (currently mainly in respect of Swap and Advance transactions) should be calculated and presented per fair value. The changes which will apply to the fair value should be assigned to Profit and Loss, as compared with the current situation in which the Swap transactions and most of the Advance transactions are presented at naïve value, according to their contractual / liability value.

4. Analysis and adoption of IFRS

The Company is prepared for the adoption of the required changes in the business procedures and working methods, analysis and finding solutions, analyzing the various methods of dealing with the options of the IFRS and implementing the solutions, including the changes required in the information system, formulating regulations and so on.

5. Additional affects

Following the transition to the international standards, changes will be created in the accounting treatment (cessation of implementation of SFAS 71 and coordination of the Financial Statements), which have significant implications on the affect of the accounting exposure of changes on the Company's currency exchanges, and according it will be necessary to re-examine the protection policies against the affect of this exposure.

O. Appointment of an additional accountant

Pursuant to the decision of the general assembly, the accountancy firm, Brightman Almagor & Co. was appointed as of January 1, 2006, as co-accountants with the Company's current accountants.

P. Reference to the structural changes and the establishment of new subsidiary companies in the Company's insurance policies

On January 11, 2007 the Company's general assembly approved the insurance policies for 2007, which include, inter alia, the following clauses:

1. Required amendments in accordance with the Law and Government decisions - the insurer agrees and confirms that the Company is entitled to implement the provisions of the Electricity Sector Law, 5756-1996 and/or the provisions of the Government Companies Law, 5735-1975 and their amendments as may be and/or any other law and/or government decision in respect of mandatory changes pursuant to these laws relating to subsidiary companies and/or affiliated companies, without prior approval being demanded or requested from the insurance company, while maintaining the insurance coverage according to the policy. The Company shall give the insurer prior written notice pertaining to any aforesaid action.

2. New subsidiary companies - the insurance coverage will be valid in respect of the new subsidiary companies in the event of structural changes independent of the extent of their assets.

Q. Sources of finance

The international rating companies, Moody's and S&P rated the Company in 2003 to Baa2 and BBB+ with negative forecasts, accordingly. In June 2005, Moody's announced a change in methodology by which the Company's rating remained as Baa2, but its negative forecast was improved to stable forecast.

On November 22, 2006, Maalot The Israel Securities Rating Co. Ltd (hereinafter: Maalot) notified the Company of a drop in the rating of its debentures from AAA to AA+/Negative. Furthermore, Maalot announced initial rating of AA+/Negative for bonds in the amount of NIS 1.5 billion, which were issued by the Company during 2006-2007.

1. Sources for long-term capital

During the reported period, loans and securities in the total amount of NIS 3,186 million were raised from the following sources:

	In NIS millions
State guaranteed US$ loans	951
NIS bond issue	1,964
Foreign currency loans	271
Total	**3,186**

* During the reported period, the Company received a loan from Citibank, with State of Israel guarantee and insured by OPIC (a US government agency) in the amount of US$ 204.6 million, from a loan framework in the amount of US$ 250 million for a period of 20 years. This loan was received for financing the sea section of the natural gas project in Israel. The insurance received from OPIC generally enables receipt of preferred credit terms over the usual credit terms.

Q. Sources of finance (cont.)

2. Securities and bank and other liabilities

The Company is burdened with liabilities in respect of loans and bonds. The Company's balance of the loans and long term and very long term securities as of December 31, 2006 is approximately NIS 39,918 million, according to the following:

CPI linked NIS liabilities	**In NIS millions**
Public issue of CPI linked bonds	10,344
CPI linked loans from indemnity funds	1,944
Other CPI linked loans[(a)]	1,038
Total linked NIS	**13,326**
Public issue of non-linked bonds	591
US Dollar linked liabilities	
From private offer to sell bonds in the United States in US$	10,562
US$ Loans[(b)]	7,103
From private offer to sell bonds in the Europe in US$	1,141
Total in US Dollar	**18,806**
From private offer to sell bonds in the Japan in Japanese Yen	3,020
Euro loans[(c)]	5,095
Swiss Franc loans	97
Pound Sterling loans	35
Total	40,970
Less clearing/premium on bonds, current maturities, costs Issue and protection transactions, net	(1,052)
Total securities and bank and other liabilities	**39,918**

(a) Including State of Israel guaranteed loans of NIS 1,016 million.
(b) Including State of Israel guaranteed loans of NIS 6,665 million.
(c) Including State of Israel guaranteed loans of NIS 39 million.

A portion of the real exposure in respect of the linked and nominal foreign currency liabilities, in an amount of NIS 15.65 billion, were transferred to the electricity consumers (see Note 3.a to the Financial Statements) Fixed foreign currency loans or foreign currency linked loans of NIS 6,529 million were raised at floating interest which changes from time to time and the balance at fixed interest, as fixed at the time of raising the capital.

3. The average long term credit as of December 31, 2006 - credit was taken from banks and others. The average credit for the reported period was NIS 44,042 million and most of it in long term loans and securities (including exchange transactions and clearing of bonds).

4. The average short term credit as of December 31, 2006 - the credit was taken from banks and others. Average credit for the reported period, NIS 3,382 million, mostly in short term loans, overdraft and current maturities on the long term loans.

5. The average credit from suppliers as of December 31, 2006 - the average credit terms from suppliers was 48 days. Average credit from suppliers for the reported period - NIS 1,560 million

6. The average credit to customers as of December 31, 2006 - the average credit terms to customers was 52 days. Average credit to customers for the reported period - NIS 2,972 million

R. Contributions

The Company is prevented from contributing due to the directives of the Government Companies Authority.

S. Quality of the environment

See Note describing the Company's business, Sections 2.1.13, 2.3.10

T. Organizational structure

For a description of the organizational structure, number of employees according to areas of activities within the organizational structure - see description of the Company's businesses in the report in Sections 2.1.9, 2.2.8, 2.3.9

U. Distribution of dividends

See Note 1 e to the Financial Statements and Statement of Changes in Equity

V. Taxation

See Note 2 p and Note 19 to the Financial Statements

W. Legal proceedings

See Note 21 to the Financial Statements

X. Property - real estate and attachments

See Note 2 ae 5 to the Financial Statements

Y. Events following balance sheet date

See Note 32 to the Financial Statements

The Board of Directors and executive management express their appreciation to the Company's employees and its managers.

Mr. Uri Z. Ben-Nun
CEO

Mr. Mordechai Friedman
Chairman of the Board of Directors

Date of approval of this report: March 29, 2007

Annual Directors' Report

Submitted to the 84th General Meeting

Dear Shareholders,

The Directors of the Israel Electric Corporation are pleased to present their Report for the year ended December 31, 2006, the Balance Sheet as of December 31, 2006, and the Statement of Income for the year then ended.

1. In 2006, the income before taxes on income amounted to approximately NIS 332 million, as compared with income of approximately NIS 604 million in 2005.

This decrease primarily originates from an increase in the cost of fuel consumption, expenses relating to renovation work, war damages and an allowance for doubtful accounts, all mainly offset by an increase in revenues resulting from increased electricity consumption, the gas incentive and the update of electricity rates. There has also been an increase in financial expenses.

Net income for 2006 totaled approximately NIS 253 million compared to net income of NIS 1,284 million in 2005 (including a gain from a change in the tax rate of approximately NIS 837 million).

2. In accordance with the policy of the Government Companies Authority, a provision was recorded in the financial statements for a dividend in the amount of approximately NIS 160 million with respect to the payment of a dividend, which is in reference to the Company's earnings before distribution of employee bonuses, as they were included in the Company's financial statements that were approved on March 29, 2007.

The Company's Board of Directors does not recommend to the general meeting that a dividend will be distributed at this time, which is due to various events which could affect the Company's profitability, equity and financial position.

The Company intends to apply to the director of the Government Companies Authority to obtain its approval of this recommendation.

On behalf of the Board of Directors,

Mr. Michael Lazzar
Director

Mr. Mordechai Friedman
Chairman of the
Board of Directors

Date: March 29, 2007

Auditors' Report

To the Shareholders of The Israel Electric Corporation Limited

We have audited the accompanying balance sheet of The Israel Electric Corporation Limited (the "Company") as of December 31, 2006, and the related statements of income, changes in shareholders' equity and cash flows for the year ended December 31, 2006. These financial statements are the responsibility of the Company's Board of Directors and its management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements as of December 31, 2005 and 2004 and for each of the years then ended were audited solely by Kost, Forer, Gabbay and Kasierer, Certified Public Accountants, whose report dated March 29, 2007 included an unqualified opinion.

We conducted our audit in accordance with generally accepted auditing standards in Israel including those prescribed by the Israeli Auditors' Regulations (Auditor's Mode of Performance) - 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's Board of Directors and its management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 2.a.3, the Minister of Finance prescribed in the regulations principles for the preparation of the Company's financial statements, in accordance with his authority in section 33.a to the Government Companies Law. Pursuant to these principles, the Company shall continue reporting in values adjusted for the changes in the purchasing power of the Israeli currency pursuant to the provisions of Opinion No. 36 (including the provisions prescribed in Opinions No. 40, 50 and 56) of the Institute of Certified Public Accountants in Israel, until December 31, 2007.

In our opinion, the financial statements referred to above present fairly, in conformity with generally accepted accounting principles in Israel and in accordance with the matter discussed in the preceding paragraph, in all material respects, the financial position of the Company as of December 31, 2006 and the results of its operations, the changes in its shareholders' equity and its cash flows for the year ended December 31, 2006. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of Annual Financial Statements) - 1993.

Notes 2.ee and 33 include additional information that is required pursuant to provisions of the Government Companies Authority (by virtue of section 33.b to the Government Companies Law), excluding information regarding land rights as discussed in Note 2.ee.5.

Without qualifying our above opinion, we draw attention to the following matters:

1. To Note 1.a to the financial statements regarding the stance of the Company's management and Board of Directors with respect to the restructuring in the Company. The Company's management and Board of Directors believe the Company's restructuring cannot be executed and implemented (in accordance with Amendment No. 5 to the Electricity Sector Law) without reaching an agreement with the Company's employees and the holders of its debentures as well as with the Company's remaining creditors, in a manner that will insure that the Company will be able to meet all its existing obligations towards them by law and the agreements entered into by the Company. The above Note also states that the Company's management and Board of Directors believe that it is the State's responsibility to act to implement Amendment No. 5 in a manner that will guarantee that the Company will be able to meet its obligations, including to its creditors.

2. To Notes 3.b.9 and 3.c to the financial statements according to which if the electricity rates are not updated as required by the changes that have occurred subsequent to the establishment of the previous rate base and as required by the transition to International Financial Reporting Standards (IFRS), this could have a material adverse effect on the Company's financial position, its economic rating and ability to repay its debts, with all the grave sectorial and national ramifications involved.

3. To Note 1.a.4 to the financial statements regarding the assets acquisition.

4. To Note 21.b (subsections 1, 2 and 3) to the financial statements regarding class action lawsuits and other material claims that were filed against the Company.

5. To Notes 2.p and 19.j.5 to the financial statements according to which the financial statements include a deferred tax liability in respect of the adjustment to the Israeli Consumer Price Index that is non-deductible for tax purposes of depreciable assets (except for immaterial buildings), whose depreciation is carried over at least 20 years from their initial operation. The Company is of the opinion that the accounting treatment as above is necessary in order to create an adequate correlation between carrying the depreciation in respect of these assets and their respective tax expenses.

Kost Forer Gabbay & Kasierer
A Member of Ernst & Young Global

Brightman Almagor & Co.
Certified Public Accountants

March 29, 2007

Auditors' Report

To the Shareholders of The Israel Electric Corporation Limited

We have audited the accompanying balance sheet of The Israel Electric Corporation Limited (the "Company") as of December 31, 2005 and the related statements of income, changes in shareholders' equity and cash flows for each of the years ended December 31, 2005 and 2004. These financial statements are the responsibility of the Company's Board of Directors and its management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in Israel including those prescribed by the Israeli Auditors' Regulations (Auditor's Mode of Performance) - 1973. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Financial Statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Company's Board of Directors and its management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 2.a.3, the Minister of Finance prescribed in the regulations principles for the preparation of the Company's financial statements, in accordance with his authority in section 33.a to the Government Companies Law. Pursuant to these principles, the Company shall continue reporting in values adjusted for the changes in the purchasing power of the Israeli currency pursuant to the provisions of Opinion No. 36 (including the provisions prescribed in Opinions No. 40, 50 and 56) of the Institute of Certified Public Accountants in Israel, until December 31, 2007.

In our opinion, the financial statements referred to above present fairly, in conformity with generally accepted accounting principles in Israel and in accordance with the matter discussed in the preceding paragraph, in all material respects, the financial position of the Company as of December 31, 2005 and the results of its operations, the changes in its shareholders' equity and its cash flows for each of the years ended December 31, 2005 and 2004. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of Annual Financial Statements) - 1993.

Notes 2.ee and 33 include additional information that is required pursuant to provisions of the Government Companies Authority (by virtue of section 33.b to the Government Companies Law), excluding information regarding land rights as discussed in Note 2.ee.5.

Without qualifying our above opinion, we draw attention to the following matters:

1. To Note 1.a to the financial statements regarding the stance of the Company's management and Board of Directors with respect to the restructuring in the Company. The Company's management and Board of Directors believe the Company's restructuring cannot be executed and implemented (in accordance with Amendment No. 5 to the Electricity Sector Law) without reaching an agreement with the Company's employees and the holders of its debentures as well as with the Company's remaining creditors, in a manner that will insure that the Company will be able to meet all its existing obligations towards them by law and the agreements entered into by the Company. The above Note also states that the Company's management and Board of Directors believe that it is the State's responsibility to act to implement Amendment No. 5 in a manner that will guarantee that the Company will be able to meet its obligations, including to its creditors.

2. To Notes 3.b.9 and 3.c to the financial statements according to which if the electricity rates are not updated as required by the changes that have occurred subsequent to the establishment of the previous rate base and as required by the transition to International Financial Reporting Standards (IFRS), this could have a material adverse effect on the Company's financial position, its economic rating and ability to repay its debts, with all the grave sectorial and national ramifications involved.

3. To Note 1.a.4 to the financial statements regarding the assets acquisition.

4. To Note 21.b (subsections 1, 2 and 3) to the financial statements regarding class action lawsuits and other material claims that were filed against the Company.

5. To Notes 2.p and 19.j.5 to the financial statements according to which the financial statements include a deferred tax liability in respect of the adjustment to the Israeli Consumer Price Index that is non-deductible for tax purposes of depreciable assets (except for immaterial buildings), whose depreciation is carried over at least 20 years from their initial operation. The Company is of the opinion that the accounting treatment as above is necessary in order to create an adequate correlation between carrying the depreciation in respect of these assets and their respective tax expenses.

Kost Forer Gabbay & Kasierer
A Member of Ernst & Young Global

Haifa, Israel
March 29, 2007

Government Companies Regulations

(Additional report regarding actions taken and statements made to secure the accuracy of the financial statements and directors' report), 2005

I, Avner Yehudai, certify that:

1. I have reviewed the annual financial statements and directors' report of The Israel Electric Corporation Limited (the "Company") for 2006 (collectively - "the reports").

2. To the best of my knowledge and after reviewing the reports, they do not contain any untrue statement of a material fact or omit to state a material fact necessary not to make the statements made, in light of the circumstances under which such statements were made, misleading with respect to the period covered by the reports.

3. To the best of my knowledge and after reviewing the reports, the financial statements and other financial information included in the directors' report fairly present, in all material respects, the financial condition, results of operations, changes in shareholders' equity and cash flows of the Company as of, and for, the periods presented in the reports.

4. The Company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures for the Company and we have designed such disclosure controls and procedures or had them designed under our charge to ensure that material information relating to the Company is made known to us by others in the Company particularly during the period in which the reports were prepared.

5. The Company's other certifying officers and I have disclosed, based on our most recent evaluation, to the Company's auditors and the Company's board of directors:
a. All significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data.
b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls.

There is nothing in the aforesaid to derogate from my responsibility or the responsibility of anyone else, pursuant to any law.

Avner Yehudai
Senior Vice-President Finance and Economic

March 29, 2007

Government Companies Regulations

(Additional report regarding actions taken and statements made to secure the accuracy of the financial statements and directors' report), 2005

I, Uri Z. Ben-Nun, certify that:

1. I have reviewed the annual financial statements and directors' report of The Israel Electric Corporation Limited (the "Company") for 2006 (collectively - "the reports").

2. To the best of my knowledge and after reviewing the reports, they do not contain any untrue statement of a material fact or omit to state a material fact necessary not to make the statements made, in light of the circumstances under which such statements were made, misleading with respect to the period covered by the reports.

3. To the best of my knowledge and after reviewing the reports, the financial statements and other financial information included in the directors' report fairly present, in all material respects, the financial condition, results of operations, changes in shareholders' equity and cash flows of the Company as of, and for, the periods presented in the reports.

4. The Company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures for the Company and we have designed such disclosure controls and procedures or had them designed under our charge to ensure that material information relating to the Company is made known to us by others in the Company particularly during the period in which the reports were prepared.

5. The Company's other certifying officers and I have disclosed, based on our most recent evaluation, to the Company's auditors and the Company's board of directors:

a. All significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data.

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls.

There is nothing in the aforesaid to derogate from my responsibility or the responsibility of anyone else, pursuant to any law.

Uri Z. Ben-Nun
Chief Executive Officer

March 29, 2007

Government Companies Regulations

(Additional report regarding actions taken and statements made to secure the accuracy of the financial statements and directors' report), 2005

I, Michael Lazzar, certify that:

1. I have reviewed the annual financial statements and directors' report of The Israel Electric Corporation Limited (the "Company") for 2006 (collectively - "the reports").

2. To the best of my knowledge and after reviewing the reports, they do not contain any untrue statement of a material fact or omit to state a material fact necessary not to make the statements made, in light of the circumstances under which such statements were made, misleading with respect to the period covered by the reports.

3. To the best of my knowledge and after reviewing the reports, the financial statements and other financial information included in the directors' report fairly present, in all material respects, the financial condition, results of operations, changes in shareholders' equity and cash flows of the Company as of, and for, the periods presented in the reports.

4. The Company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures for the Company and we have designed such disclosure controls and procedures or had them designed under our charge to ensure that material information relating to the Company is made known to us by others in the Company particularly during the period in which the reports were prepared.

5. The Company's other certifying officers and I have disclosed, based on our most recent evaluation, to the Company's auditors and the Company's board of directors:

a. All significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data.

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls.

There is nothing in the aforesaid to derogate from my responsibility or the responsibility of anyone else, pursuant to any law.

Michael Lazzar
Director

March 29, 2007

Government Companies Regulations

(Additional report regarding actions taken and statements made to secure the accuracy of the financial statements and directors' report), 2005

I, Mordechai Friedman, certify that:

1. I have reviewed the annual financial statements and directors' report of The Israel Electric Corporation Limited (the "Company") for 2006 (collectively - "the reports").

2. To the best of my knowledge and after reviewing the reports, they do not contain any untrue statement of a material fact or omit to state a material fact necessary not to make the statements made, in light of the circumstances under which such statements were made, misleading with respect to the period covered by the reports.

3. To the best of my knowledge and after reviewing the reports, the financial statements and other financial information included in the directors' report fairly present, in all material respects, the financial condition, results of operations, changes in shareholders' equity and cash flows of the Company as of, and for, the periods presented in the reports.

4. The Company's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures for the Company and we have designed such disclosure controls and procedures or had them designed under our charge to ensure that material information relating to the Company is made known to us by others in the Company particularly during the period in which the reports were prepared.

5. The Company's other certifying officers and I have disclosed, based on our most recent evaluation, to the Company's auditors and the Company's board of directors:
   a. All significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data.
   b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls.

There is nothing in the aforesaid to derogate from my responsibility or the responsibility of anyone else, pursuant to any law.

Mordechai Friedman
Chairman of the Board of Directors

March 29, 2007

Balance Sheets

	Note	December 31, 2006	December 31, 2005
CURRENT ASSETS			
Cash and cash equivalents		721	1,220
Short-term investments	4	211	403
Trade receivables for sales of electricity	5	2,871	2,843
Other accounts receivable - unbilled	6	678	974*
Inventory - coal and fuel oil	7	1,620	1,657
Inventory stores		206	165
		6,307	7,262
NON-CURRENT ASSETS			
Long-term receivables	8	2,433	2,141
Investments in investee companies	9	57	54
Investments in debentures	10	838	649
Fixed assets in use, net		50,777	50,754
Fixed assets under construction		7,187	7,090
Fixed assets, net	11	57,964	57,844
Other assets, net	12	-	404
		67,599	**68,354**

* Reclassified.

The accompanying notes are integral part of financial statements.

Mr. Avner Yehudai	**Mr. Uri Z. Ben-Nun**	**Mr. Michael Lazzar**	**Mr. Mordechai Friedman**
Senior Vice-President Finance and Economics	Chief Executive Officer	Director	Chairman of the Board of Directors

Date of approval of Financial Statements: March 29, 2007

In millions of adjusted NIS in December 31, 2006 purchasing power

Balance sheets (cont.)

	Note	December 31, 2006	December 31, 2005
CURRENT LIABILITIES			
Credit from banks and others	14	2,801	3,516
Liabilities to suppliers and service suppliers		1,480	1,535
Customer advances, net of work in progress	15	270	160
Accounts payable and credit balances	16	2,497	1,886*
		7,048	7,097
LONG-TERM AND VERY LONG-TERM LIABILITIES, NET			
Liabilities incurred through employee-employer relations, net.	17	712	671
DEBENTURES AND LIABILITIES TO BANKS			
Long-term debentures, net		24,772	25,357
Liabilities to banks		12,419	12,593
Other long-term liabilities		2,206	2,471
Very long-term debentures, net		521	573
	18	39,918	40,994
DEFERRED TAXES, NET	19	4,337	4,261
PERPETUAL DEBENTURES	20		
COMMITMENTS AND CONTINGENT LIABILIITES	21	2,098	-
SHAREHOLDERS' EQUITY	31.a	13,486	15,331
		67,599	**68,354**

* Reclassified.

The accompanying notes are an integral part of the financial statements.

In millions of adjusted NIS in December 31, 2006 purchasing power

Statements of Income

	Note	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004
Revenues	24	17,590	16,748	14,925
Cost of Operating the Electricity System:				
Wages		1,521	1,332	1,289
Fuel		8,082	7,833	5,685
Purchases of electricity		83	73	56
Operation of the generation system		579	554*	458*
Operation of the transmission and distribution system		289	240	239*
Depreciation		2,889	2,727	2,644
		13,443	12,759	10,371
Profit from operating the Electricity System		**4,147**	**3,989**	**4,554**
Sales and marketing expenses	25	763	720*	675*
Administrative and general expenses	26	766	638*	621*
Expenses from liabilities to pensioners, net		117	106	82
		1,646	1,464	1,378
Income from current operations		**2,501**	**2,525**	**3,176**
Financial expenses, net:				
Financial expenses		1,704	2,063	2,412
Capitalization of financial expenses		(174)	(238)	(433)
Transfer of financial income to a regulatory liability		646	88	2
Financial expenses, net	28	2,176	1,913	1,981
Other expenses (income), net	29	(7)	8	100
Income from current operations before income taxes		**332**	**604**	**1,095**
Income taxes - deferred:				
Deferred taxes		88	164	340
Effect of change in tax rate on deferred taxes		-	(837)	(943)
Total income taxes	19	88	(673)	(603)
Income from current operations after provision for income taxes		**244**	**1,277**	**1,698**
Equity in earnings of affiliated companies, net		9	7	3
Income before special items		**253**	**1,284**	**1,701**
Cumulative effect to the beginning of the year of the change in accounting principles, net		-	-	1,159
Net income		**253**	**1,284**	**2,860**

* Reclassified.

The accompanying notes are an integral part of the financial statements.

In millions of adjusted NIS in December 31, 2006 purchasing power

Statements of Changes in Shareholders' Equity

	Paid-up Share Capital	Perpetual Debentures	Capital Reserves	Provision for Dividend	Retained Earnings	Total
		(Note 20)	(Note 22)			
Balance at January 1, 2004	940	2,098	851	109	7,456	11,454
CHANGES DURING 2004						
Net income					2,860	2,860
Interest on perpetual debentures (net of NIS (33) million from tax savings)(1)					(76)	(76)
Dividend provided for 2003(2)				(109)	-	(109)
Dividend provided for 2004				1,495	(1,495)	-
Balance at December 31, 2004	**940**	**2,098**	**851**	**1,495**	**8,745**	**14,129**
CHANGES DURING 2005						
Net income					1,284	1,284
Interest on perpetual debentures (net of NIS (27) million from tax savings)(1)					(82)	(82)
Dividend payable for 2004				(35)	35	-
Dividend provided for 2005(3)				736	(736)	-
Balance at December 31, 2005	**940**	**2,098**	**851**	**2,196**	**9,246**	**15,331**
CHANGES DURING 2006						
Net income					253	253
Reclassification		(2,098)				(2,098)
Erosion of dividend provided for 2005(3)				2	(2)	-
Dividend provided for 2006(3)				160	(160)	-
Balance at December 31, 2006	**940**	**-**	**851**	**2,358**	**9,337**	**13,486**

(1) Net of erosion of interest payable to the beginning of the period.
(2) The dividend was paid on January 18, 2005.
(3) a. As stated in Note 1e, the policy of the Government Companies Authority ("the Companies Authority") is to distribute a dividend at a rate of 60% of the annual current net income, before profit-based bonus payment to employees.
b. The amount of the dividend according to this policy for 2004 is about NIS 1,495 million, for 2005, it is about NIS 736 million and for 2006, it is about NIS 160 million.
c. The Company's Board of Directors decided to recommend to the general meeting the distribution of a dividend in the amount of NIS 118 million in respect to the earnings for 2004, which is because in its opinion, a dividend should not be distributed out of the earnings deriving from a change in an accounting policy and from an amount deriving from a decrease in the tax rate that occurred during the reported year (see also Note 1e below).
d. The Company applied to the Director of the Companies Authority to receive his approval of the above recommendation for 2004 and as of the date of signing these financial statements, has not yet received his reply.
e. For the time being, the Board of Directors does not recommend the distribution of a dividend for 2005 and 2006.

The accompanying notes are an integral part of the financial statements

Statements of Cash Flow

	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004
CASH FLOW FROM OPERATING ACTIVITIES			
Net income according to statement of income	253	1,284	2,860
Adjustments required to reconcile net income to net cash provided by operating activities - Annex A	3,910	2,698	1,219
Net cash provided by operating activities	**4,163**	**3,982**	**4,079**
CASH FLOW FROM INVESTING ACTIVITIES			
Purchase of fixed assets	(3,565)	(4,483)	(4,619)
Deposit in excess funding over reserve for pension	(626)	(65)	-
Purchase of marketable securities and other long-term investments	(166)	(649)	-
Proceeds from sale of fixed assets	38	28	21
Realization (purchase) of short-term marketable securities, net	412	(401)	-
Long-term loans granted	(127)	(356)	(631)
Collection of long-term debts	37	55	72
Corporation trust deposit in banks	(211)	-	-
Net cash used in investing activities	**(4,208)**	**(5,871)**	**(5,157)**
CASH FLOW FROM FINANCIAL ACTIVITIES			
Dividend paid	-	(109)	-
Issuance (repayment) of short-term debentures	-	(293)	284
Interest on perpetual debentures	-	(109)	(105)
Issuance of long-term debentures, net	1,964	4,960	999
Long-term loans received from provident funds	-	-	276
Other long-term loans received, net	1,223	308	1,440
Long-term debentures repaid	(1,596)	(1,429)	(172)
Repayment of long-term loans from provident funds	(219)	(205)	(299)
Other long-term loans repaid	(1,316)	(1,152)	(1,450)
Deposit (repayment) of swap transactions, net	(492)	170*	-
Short-term credit from banking institutions, net	(18)	(1)	(13)
Net cash provided by (used in) financial activities	**(454)**	**2,140**	**960**
Increase (decrease) in cash and cash equivalents	**(499)**	**251**	**(118)**
Balance of cash and cash equivalents at the beginning of the year	**1,220**	**969**	**1,087**
Balance of cash and cash equivalents at the end of the year	**721**	**1,220**	**969**

* Reclassified.

The accompanying notes are an integral part of the financial statements

In millions of adjusted NIS in December 31, 2006 purchasing power

Statements of Cash Flow (cont.)

Annex A - Adjustments required to reconcile net income to net cash provided by operating activities

	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004
INCOME AND EXPENSES NOT AFFECTING CASH FLOW:			
Equity in earnings of affiliated companies, net of dividend received	(4)	(5)	(1)
Depreciation and amortization	3,200	3,149	3,039
Deferred taxes, net	88	(673)	(603)
Increase (decrease) in liabilities incurred through employee-employer relations, net	29	10	(73)
Erosion of loans and debentures, net (including swap transactions)	(575)	(260)*	(493)
Decrease in regulatory asset due to financial expenses, net	701	215	229
Decrease in other regulatory assets	470	362*	325
Erosion (excess) in collectible debts	26	(3)	-
Cumulative effect to the beginning of the year of the change in accounting principles, net	-	-	(1,159)
Capital loss on the sale of fixed assets	1	40	21
Increase in value of marketable securities, net	(32)	(2)	-
	3,904	2,833	1,285
CHANGES IN ASSETS AND LIABILITIES:			
Increase in trade receivables for sales of electricity	(28)	(72)	(446)
Decrease (increase) in accounts receivable - unbilled	(77)	41	90
Decrease (increase) in inventory stores	(41)	12	(9)
Decrease (increase) in inventory - coal and fuel oil	37	(294)	(329)
Increase in customer advances, net of work in progress	110	62	12
Increase (decrease) in liabilities to suppliers and service suppliers	(55)	(211)	226
Increase in accounts payable and credit balances	60	327*	390
	6	(135)	(66)
	3,910	**2,698**	**1,219**

* Reclassified.

The accompanying notes are an integral part of the financial statements

Statements of Cash Flow (cont.)

Annex B - Activities not reflected in the statements of cash flow

	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004
Proceeds received from Government insurance company related to linkage to differences for indexed debentures against the payment of the same amount to the holders of the debentures	12	6	6

The accompanying notes are an integral part of the financial statements

Note 1: The Legal Environment in which the Company Operates

The Company is engaged in the generation, transmission, distribution and trade of electricity, and establishes the infrastructures required for these activities.

a. The Electricity Sector Law and the amendments thereto

Since March 5, 1996, the Company has operated in accordance with the Electricity Sector Law - 1996 (hereinafter: "the Electricity Sector Law"), which has been amended several times, the latest of which was approved on March 1, 2007 (Amendment No. 5). Further, the Company is subject to the provisions of the Government Companies Law, 1975 ("the Government Companies Law").
As for the operating licenses for the Company's activities pursuant to the Electricity Sector Law (see section b below).

The purpose of the Electricity Sector Law is to regulate the activities in the Electricity Sector for the benefit of the public, while ensuring reliability, availability, quality and efficiency and facilitating competition and reducing costs.

As stated above, the Electricity Sector Law has been amended several times, the latest of which in March 2007 and this, among others, in order to regulate structural changes in the Electricity sector (including the Company's future structure). The principal provisions of the law as described below are pursuant to the law as it was formulated after Amendment No. 5.

1. The main elements of the Electricity Sector Law are as follows:

The main principles for granting licenses by the Public Utilities Authority - Electricity ("the Electricity Authority") as approved by the Minister of National Infrastructures (hereinafter - "the Minister") as prescribed by Electricity Sector Law, including several restrictions.

General policy is determined for granting licenses, pursuant to which where in effect the various activities in the electricity sector will be segregated, which in general forbids the granting of a license to more than one activity to a person (subject to the exceptions that will be listed below), and prescribes caps for the scope of generation capability inherent in the generation licenses held by a person, and the scope of distribution inherent in the distribution licenses held by a person. In addition, it imposes a series of restrictions on the holding of licenses in a cluster of companies, the principal element of which is the imposing of restrictions on cross-holdings of licenses of various types and the scope of generation capacity and distribution that it is possible to hold in a cluster of companies (see subsections e-h below). The Company has licenses for 100% of the scope of distribution, supply and transmission, and a similar rate for the scope of generation, and for the generation units whose construction was finalized by March 2003, in effect until July 1, 2007 (for details regarding generation units for which generation licenses have not yet been granted, see section b below). In addition, interim provisions were determined in the Electricity Sector Law for the implementation of these restrictions in 2007-2013 (regarding transition provisions and licenses that were granted to the Company see 1.a.3 and 1.b below).

Below are the principal rules and restrictions for granting licenses prescribed in the Electricity Sector Law, as amended:

a. A license will be granted for one activity, place or defined area, and it is possible that different generation licenses will be granted in proportion to one power station.
b. The Electricity Authority, as approved by the Minister, is entitled to grant a license for activities (generation, transmission, distribution, supply and trade in electricity), to prescribe therein terms, as well as to restrict or not to restrict the period it is in force.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

1. The main elements of the Electricity Sector Law are as follows: (cont.)

c. No person will be granted a license for more than one activity, except for:
   - A generation license may be granted together with a supply license provided that attention is given, among others, to the developments in the competition in the electricity sector. It should be noted that Amendment No. 5 eliminated the possibility of granting a supply license to a holder of a distribution license. Nevertheless, Amendment No. 5 prescribes a transition provision whereby the holder of a distribution license that is a government company or subsidiary may be granted a supply license until January 1, 2012 and the Ministers, in consultation with the Companies Authority and the Electricity Authority, are entitled to determine in a decree that a supply license will be granted as above until January 1, 2013;
   - Amendment No. 5 eliminates the option of granting a limited scope generation license to the holder of a transmission license but it prescribes that the holder of a license for managing the system or its subsidiary if so determined in the license and being essential for the reliability of the power supply, may also be granted generation licenses provided that these licenses are not granted in respect of 5% or more of the generation scope of the electricity sector and if the Minister considers that special circumstances are at play, 10% or more of said scope.

d. A generation license shall not be granted to a person that, following receipt of the requested license, will hold 30% or more of the scope of generation capability in the electricity sector, and a distribution license shall not be granted to a person that, following receipt of the requested license, shall hold 25% or more (prior to Amendment No. 5, the quantity referred to 20%) of the scope of distribution in the electricity sector.

e. Generation or distribution licenses shall not be granted to someone holding means of control in the holder of a transmission license.

f. A transmission license shall not be granted to someone holding means of control in the holder of a generation license or the holder of a distribution license.

g. A generation license shall not be granted to someone holding means of control in:
   - The holder of a distribution license at a scope of 10% or more of the distribution scope in the electricity sector, or;
   - The holder of a distribution license if, following his receipt of the requested license, he shall hold by the means of control 10% or more of the scope of generation capability in the electricity sector.

h. A distribution license shall not be granted to the holder of means of control in:
   - The holder of a generation license, who holds 10% or more of the scope of generation capability in the electricity sector, or;
   - The holder of a generation license if, following his receipt of the requested license, he shall hold by means of control 10% or more of the scope of distribution in the electricity sector.

i. Amendment No. 5 stipulates that a license shall not be granted if after receiving the license, there will be an individual other than the State holding a license for management of the system or holding the means of control in said licensee and will also hold a distribution, generation or supply license or will hold the means of control in said licensee, other than as stated in 1.b below.

j. The Ministers of National Infrastructures and Finance ("the Ministers"), in consultation with the Electricity Authority and with the Companies Authority, are entitled to determine rates which are different from the rates prescribed in sections d, g and h above, that detail the restrictions on granting generation and distribution licenses, as stated above, if they are convinced that the matter is essential to advancing the objectives of the Law (different rates could include both an increase and a decrease in the scope of generation and distribution capability that any person whomsoever could hold or that the license holder could hold through the holding of the means of control in other license holders, as applicable), as well as to determine additional restrictions to the restrictions described above for granting licenses.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

1. The main elements of the Electricity Sector Law are as follows: (cont.)

Amendment No. 5 modifies the transition periods prescribed by the Electricity Sector Law prior to the amendment and determines new transition provisions, schedules and milestones for the Company's restructuring as follows:

k. Despite the provisions of the Electricity Sector Law and the provisions of the licenses granted to the Company pursuant to the Electricity Sector Law, that were in effect on the eve of the end of the transition period (March 3, 2006), the licenses will remain in effect for all the activities previously carried out according to the licenses until July 1, 2007 (as for the extension of the decrees beyond said date, see section n. below).

l. Amendment No. 5 regulates the activities of the Company's power stations that were not entitled to a license prior to the amendment and prescribes that the Electricity Authority, under the Minister's approval, is entitled to grant generation licenses despite the restrictions stipulated in the Electricity Sector Law in respect of the power stations included in the development plan approved by the Electricity Sector Law whose establishment commenced prior to March 4, 2007 for a period during which the licenses mentioned in a. above are in effect. As for the elaboration on this matter, see b.3 below.

m. The Amendment distinguished the activities of managing the system from the transmission activity. The Amendment stipulates that the system management activity requires a license by law (an essential service provider license) and must therefore be embedded in a separate corporation outside the Company's corporate structure. At this stage, the Company will be able to continue the system management activity and the license to the new corporation that will manage the system will be granted by September 2, 2008.

The Electricity Authority, under the Minister's approval, is entitled to grant generation and distribution licenses to a government company or subsidiary in respect of the electric system operated in accordance with the above licenses as stated in a and b above even if the provisions according to which an individual shall not hold 30% or more of the electricity sector's generation capacity after receiving the generation license and 25% or more of the electricity sector's distribution scope after receiving the distribution license are not met, provided that the following stipulations are met:

1. The generation licenses shall only be granted if after receiving the license the license holder will hold power stations operating on the basis of a mixture of various types of fuels such as diesel oil, natural gas and coal. As for the matter of coal, the license applicant is not obligated to produce the coal operated electricity by itself but rather may own rights to receive electricity produced in a coal operated power station. The license holder according to this section shall be viewed as coordinating a substantial portion of the electricity sector generation capacity and will be subject to the provisions of the Electricity Sector Law regarding an essential service provider licensee as long as the Minister does not determine otherwise. The Minister's determination prior to January 1, 2015 requires the consent of the Minister of Finance.
2. Distribution licenses will be granted in such a manner that the costs of the license holders regarding the electricity facilities they use upon granting the licenses will be as similar as possible; however, the Ministers, in consultation with the Electricity Authority and the Companies Authority, are entitled to determine otherwise if they consider that it is for the advancement of the objectives of the Electricity Sector Law.
3. After receiving the license, the license holder will not hold, through another corporation, 30% or more of the electricity sector's generation capacity or 25% or more of the distribution scope in the electricity sector.
4. The license will be in effect provided that as of July 1, 2013, a government company or subsidiary will not hold, jointly or severally, more than 51% of the means of control in the holder of a distribution of generation license, as provided by this section.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

1. The main elements of the Electricity Sector Law are as follows: (cont.)

n. The Ministers, in consultation with the Electricity Authority and the Companies Authority, are entitled to extend the validity of the licenses as discussed in a. and b. above by decree as specified below:

1. An extension for the period from July 2, 2007 through November 1, 2007 - if they consider it imperative to advance the objectives of the Electricity Sector Law.
2. An extension for the period from November 2, 2007 through January 1, 2008 in the matter of generation and transmission licenses and until January 1, 2009 in the matter of distribution and supply licenses provided that the extension is in accordance with a decree that prescribes the manner of implementing the restructuring in the electricity sector whereby it will become possible, as of the effective date (see section 3 below), to grant licenses pursuant to the provisions of the Electricity Sector Law, including section m. above, in respect of all the activities for which the licenses are extended ("the implementation decree").
3. The extension of the validity of the distribution and supply licenses for a period from the end of the dates stipulated in section 2 above through the effective date (see below in this section) provided that corporations have been established pursuant to the implementation decree in a manner that will enable, as of the above mentioned dates, to grant generation and distribution licenses for those corporations pursuant to the provisions of the Electricity Sector Law, including section c above. The effective date is based on the license type as follows:
   a) System management license - until September 1, 2008.
   b) Generation license - until January 1, 2009.
   c) Distribution and supply license - until January 1, 2010.
   d) Transmission license - until December 31, 2010.
4. The extension of a transmission license beyond the period stated in section 2 above (January 1, 2008), as specified below:
   As of January 1, 2008 through September 1, 2008 - if a corporation has been established pursuant to the implementation decree in a manner that will enable granting a system management license for that corporation, as of the effective date of the transmission license (December 31, 2010) pursuant to the provisions of the Electricity Sector Law.
   As of September 2, 2008 through December 3, 2009 - if a system management license has been granted pursuant to the provisions of the Electricity Sector Law.
   As of January 1, 2010 through December 31, 2010 - if a corporation has been established pursuant to the implementation decree in a manner that will enable granting a transmission license for that corporation, as of the effective date of the transmission license (December 31, 2010) pursuant to the provisions of the Electricity Sector Law.

o. The licenses extended pursuant to section n. above will be in effect for the duration of the extension period provided that the Company will comply with their provisions, the provisions of the Electricity Sector Law and any other law.

p. 1. The Ministers will issue a decree, in consultation with the Electricity Authority and the Companies Authority, by January 1, 2011, to determine if a government company or subsidiary holding the means of control in a holder of a generation or distribution license will also be able to hold the means of control in a holder of a transmission license.
2. If the Ministers determine by decree pursuant to section (1) above that a government company or subsidiary is not allowed to hold the means of control over a transmission license holder, they will also determine the date and manner of the implementation of their stipulation provided that the date is not later than January 1, 2013 and the transmission license will be in effect conditional upon fulfilling the provisions of the decree.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

1. The main elements of the Electricity Sector Law are as follows: (cont.)

3. If the Ministers determine by decree pursuant to section (1) above that a government company or subsidiary is allowed to hold the means of control over a transmission license holder, they may also determine by same decree conditions, restrictions and provisions to apply to said stake for the purpose of advancing the objectives of the Electricity Sector Law. The transmission license will be in effect conditional upon fulfilling the provisions of the decree and the stipulations of section m.4 above.

q. As of January 1, 2009, a government company or subsidiary holding the means of control over a license holder as provided above will not engage in the engineering planning of power stations, in erecting power stations, in logistics, information technology and purchasing any type of fuel. Furthermore, a government company or subsidiary holding a license as provided above will not engage in the abovementioned activities on behalf of another corporation that holds a license according to the Electricity Sector Law; however, if corporations that are permitted to engage in said activities had been established, the Ministers will determine by decree that the Company will be able to continue engaging in said activities until January 1, 2010 and the Ministers are also entitled to determine by decree that despite the provisions pursuant to the Mandatory Tenders Law, 1992, a government company or subsidiary holding a license as provided above will grant priority to these corporations all under the conditions and the period as will be determined.

r. Despite the abovementioned in section c. above, a supply license may be granted to a government company or subsidiary holding a distribution license pursuant to the Electricity Sector Law until January 1, 2012 and the Ministers, in consultation with the Electricity Authority and the Companies Authority, are entitled to determine by decree that that company may be granted a supply license until January 1, 2013. Amendment No. 5 eliminates the possibility of granting a supply license to a holder of a distribution license subject to the abovementioned exceptions.

s. The Ministers, in consultation with the Electricity Authority and the Companies Authority, having learned that it is vital for advancing the objectives of the Electricity Sector Law, are entitled to delay by decree the dates stated in section c. above, all or some, other than the date stated in n.1 above, for a period not exceeding six months.

The Company believes that the adoption of the amendment to the Law allows it to restructure itself as a corporate structure under a graded time frame where the Company, as the parent company, will hold subsidiaries as follows: at least four companies holding a generation license and operating on the basis of a similar fuel mixture, each holding licenses covering 30% of the electricity sector's generation capacity at the most; at least four companies holding a distribution license, each holding licenses covering 25% of the sector's distribution scope at the most, with the costs relating to the electricity facilities used by each of these companies will be as similar as possible; a company holding a transmission license in respect of which the Ministers will determine, by January 1, 2011, if it shall remain in the corporate structure; and a subsidiary or subsidiaries for providing services. As of January 1, 2009, the company or subsidiaries (and the Company as well under certain conditions - as of January 1, 2010), holding the license will not be able to provide services to others but only amongst themselves and will grant priority to receiving services from the company (or companies) despite the provisions of the Mandatory Tenders Law.

At this stage, the Company will be able to continue managing the system and the license to the new corporation that will manage the system will be granted by September 2, 2008.

Until July 2013, the parent company will be able to hold 51% at the most of the means of control over the generation or distribution companies.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

2. The policy document

On February 15, 2007 (near the date of publication of Amendment No. 5 to the Electricity Sector Law), the general manager of the Ministry of National Infrastructures, the budget supervisor at the Ministry of Finance and the Director of the Companies Authority issued a document ("the policy document") that contains their recommended outline of the restructuring. Based on the Government's decision as above and the policy document, the Electricity Sector Law was amended on March 1, 2007 (Amendment No. 5).

The principal points of the policy document are as follows:

a. Company structure

The Electric Corporation ("the Company") will be a holding company held by the Government, which will hold, in stages, subsidiaries engaged in generation, delivery and distribution and companies providing services for erecting and operating power station, planning power stations, providing services and logistics, information technology and fuels. In addition, based on the Company's existing activities, a separate company will be formed, wholly owned by the Government, to manage the system, the trade and long-term planning, according to a pre-determined schedule. In the intermediate stage, the Company's management and any area of activity that is not separately incorporated will remain a part of the holding company. One of the objectives of this restructuring is to streamline the Company's operations in a manner that will add generation power to the sector while imposing minimum costs on the electricity consumers.

1. System management

A wholly owned Government company will be established for managing the system, the trade and long-term planning. The system management company will operate under supervision.

2. The transmission system

A subsidiary will be established to engage in the transmission and be in charge of electricity transmission, transformation and switching. Clear rules establishing a structural distinction and independence between the Company and the transmission company will be prescribed in order to assure its business independence and to promote competition. The control rights over the transmission company will be held with the State, all in order to secure independence and to prevent conflicts of interests within the Company.

3. The distribution system

The distribution segment will be split into four or five regional distribution companies with territorial continuity that will be structurally similar in terms of costs and scopes of activities, as far as possible. These companies will be established and act as subsidiaries of the Company, and clear rules of structural segregation and independence between the Company and the subsidiaries will be established. The distribution companies will operate under supervision.

4. Additional services

The activities regarding planning and construction of power stations, information technology, logistics and fuels will be operated by subsidiaries and clear rules of structural segregation and independence between the Company and the subsidiaries will be established.

b. Electricity generation

1. Future coal operated power stations ("D" and "E") will be established and incorporated by subsidiaries of the Company, subject to the principles specified in the policy document and the implementation of the restructuring according to the development plans approved by the Minister and subject to any law.
2. Determining the structure and establishment of the generation companies will be in such a manner so as to prevent market failures or unjust exploitation of the electricity power in the electricity sector.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

2. The policy document (cont.)

3. Clear rules of structural segregation and independence between the holding companies and the generation companies, and within the generation companies will be established in order to assure the business independence of the generation companies and to promote competition in the electricity sector.
4. Following the sale of 49% of the interests of the holding companies in the generation company, the latter will be permitted to engage in water desalination.
5. The supply segment will be attributed to the generation companies so that with their incorporation, all the electricity sector consumers will be initially attributed to these companies and by January 1, 2008, rules to guarantee freedom of choice for the consumers will be instituted. The removal of price control over the distribution and supply segments, as the consumer's ability to choose, will be gradually introduced according to consumer groups, where the control over the largest consumers will be removed at the beginning of the process down to the household consumers at the end of the process.

c. <u>Regulation and cost recognition</u>

1. The control practiced on the eve of the restructuring over all the sector's segments will continue to apply and will be removed gradually in respect of the generation and supply segments as far as the sector's terms of competition allow it. The criteria for the gradual removal of said control will be determined by September 1, 2007 by the Administration (see section e. below).
2. The recognized costs of the restructuring will be manifested in the future electricity rates.
3. The Electricity Authority's control over the rates of the subsidiaries and sister companies will take into consideration a fair return on the capital until it is removed (for generation and supply).
4. Upon the split, the Government will act to create the conditions required for the financial strength and stability of the companies in the Company's holding group and the system management company, under the reasonable business conduct of the supervised companies.

d. <u>Assignment of debts and assets</u>

- The Company will sell the assets pertaining to the operating segments that will be assigned to the new companies to these companies.
- Loans taken out by the Company will remain in its charge and will not be assigned to the new companies.
- Assets used by more than one company will be assigned to a company determined by the Ministers and proper contracts arranging the use of the assets by the other companies will be prepared under terms that will allow to achieve competition as soon as possible.
- The sale consideration will be determined at the book value of the assets in the Company's books.
- A portion of the consideration, in an amount equal to the Company's outstanding loans near the date of the transfer, will be gradually repaid by the assigned companies at dates that will allow the Company to pay its creditors the amounts secured by the loans.
- The remaining consideration will be immediately paid to the Company by the assigned companies. Funds that originate from the remaining consideration received by the Company from the subsidiaries will serve the Company to immediately invest in the share capital of the subsidiaries.
- A portion of the consideration that is not immediately disbursed will bear interest to allow the repayment of the interest on the loans taken out by the Company.
- The sale of the assets to the new companies will be such that the Company's assets and revenues subsequent to the restructuring, directly and indirectly, through its holdings in the subsidiaries, will allow the repayment of the Company's outstanding debts.
- The Administration that will implement the restructuring will be in charge of handling the contact with the Company's creditors in aspects relating to the restructuring.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

2. The policy document (cont.)

e. Setting up an Administration for carrying out the restructuring

An Administration will be set up whose duties will consist of preparing all the steps, agreements, documents and decisions required for executing all the principles determined in the general managers document based on the pre-determined schedule. Given the employees' sanctions to date (see Note 21.c below), there has been no significant progress in effecting the restructuring and the Company's appeals to the regional and national labor courts in the matter of the restructuring have yielded little success, and did not and do not permit the Company to advance the preparations required for the restructuring.

Nevertheless, on February 28, 2007, the Director of the Companies Authority addressed the Company in a letter reiterating that the implementation of the reform in the Company pursuant to the Electricity Sector Law will be carried out, among others, while examining the implications of the restructuring on the Company's liabilities and this, among others, so as to not prevent the Company from meeting its loan obligations.

The stance of the Company's management and Board of Directors regarding the structural change

In furtherance to Amendment No. 5 to the Electricity Sector Law, the Company aims to act to the best of its ability to promote its restructuring. In furtherance to the Government's decision of February 18, 2007, on February 22, 2007, the Company's Board of Directors resolved to set up an internal administration ("the headquarters") for implementing the structural change according to Amendment No. 5 as above. According to said decision, the Company's management has submitted a detailed plan for setting up the headquarters for implementing the structural change to the Board's Regulatory Committee and the plan was approved. The headquarters have not yet been established or operated due to employee sanctions (see more details in Note 21.c below).

The Company's management and Board of Directors believe that the schedules stipulated in Amendment No. 5 to the Electricity Sector Law are too near and there is doubt as to the Company's ability to perform the totality of changes required under the established schedules following Amendment No. 5.

Moreover, Amendment No. 5 provides a mere partial solution to the variety of issues raised by the expected restructuring in the Company and does not regulate the manner of executing the restructuring. In the opinion of the Company's management and Board of Directors, Amendment No. 5 cannot be implemented without reaching an agreement with the Company's employees, holders of debentures and the remaining creditors to secure that the Company will be able to meet all its outstanding obligations towards them pursuant to any law and to the agreements signed by the Company. Until the date of the approval of the financial statements, the Company and the State have not yet devised adequate plans with respect to these arrangements.

As mentioned above, the Company intends to act to the best of its ability to promote the restructuring; yet, since a substantial portion of the restructuring's elements is not under the Company's control but rather controlled by the State, the Company's management and Board of Directors believe that it is the Government's responsibility to act to implement Amendment No. 5 in a manner that will insure that the Company will be able to fulfill its liabilities, including to its creditors. In this matter, see, among other things, the letter of the Director of the Companies Authority and the policy document discussed above.

3. Below are additional provisions included in the Electricity Sector Law

a. The holder of a transmission, distribution or system management license as well as the holder of a generation license or licenses in respect of which the Minister has determined that it coordinates a substantial part of the electricity sector's generation capacity, are defined as holders of an essential service provider license. The Electricity Sector Law determines that the holder of an essential service provider license shall:

1. Provide nondiscriminatory service to the general public based on the standards established by the Electricity Authority in a reliable and efficient manner, all as stipulated in the license and in any law.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

3. Below are additional provisions included in the Electricity Sector Law (cont.)

2. Purchase electricity from a private power manufacturer and render infrastructure and backup services, all as stipulated in the license and in any law.
3. Render backup services to the holder of a self-generation license, at its request, all as stipulated in the license and in any law.
4. Act to guarantee that its services are rendered in full for the duration of the license period, including rendering services according to the development plan approved by the Electricity Sector Law, while taking all the steps needed to render such services.
   The Minister, in consultation with the Electricity Authority, may demand that a holder of such license submit to his approval a development plan, integral or segmented, for the purpose of its activities as provided by the license and if such a development plan is not submitted to the Minister's approval, such a plan will be designed for the licensee in consultation with the Electricity Authority and the licensee will have to abide by it.
   The Minister is entitled to enact regulations concerning the holder of a transmission license's responsibility for developing the electricity sector, pursuant to the development plan, including planning the electricity network.
   Furthermore, the Electricity Sector Law stipulates that the holder of an essential service provider license will prepare financial statements as determined by the Ministers, in consultation with the Minister of Justice, in the matter of the level of their specifications, the accounting principles underlying their preparation and the assertions and notes accompanying them. The holder of an essential service provider license will charge fees at rates determined by the Authority.
   The holder of a transmission license will pay the holder of another license fees at rates determined by the Authority. Should the Authority determine standards according to which the holder of an essential service provider license is entitled not to provide the service or make the purchase prescribed by the Electricity Sector Law, and may discontinue them, delay then or restrict them if it has not received fees for them according to any law or if the terms for providing the service or making the purchase as required by law have not been met.

b. The transfer, pledge and foreclosure of the license or assets
   1. A license or any part thereof cannot be transferred, pledged or foreclosed, directly or indirectly, unless with the Minister's consent. Moreover, a guarantee and/or the funds arising there from provided by the license holder cannot be foreclosed or pledged.
   2. The Minister may determine in the license that certain assets of the license holder that he believes are necessary for performing the activities prescribed by the license cannot be transferred, pledged or foreclosed, directly or indirectly, unless with the Minister's consent.

c. A private electricity manufacturer may sell electricity to the holder of an essential service provider license or another, according to the terms of the license.

d. The Electricity Authority was established to act pursuant to the objectives of the Electricity Sector Law and in accordance with Government policy, the Minister's policy or the policy of the ministers based on their authorities subject to any law in the electricity sector and to supervise that the provisions of the Electricity Sector Law and the licenses are met as well as fulfill the duties assigned to it by the Electricity Sector Law and imposed on it by any other law. The Electricity Authority's duties, among others, are as follows:
   1. Fixing rates and rate updating policies.
   2. Setting standards regarding level, nature and quality of the service provided by the essential service provider and setting standards for instances where the essential service provider licensee is not obligated to render a service or make an acquisition and subject to the development plan approved by the Minister, supervised according to said standards.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

3. Below are additional provisions included in the Electricity Sector Law (cont.)

3. The Electricity Authority has the power to establish directives in the matter of reimbursement fees to be paid by the essential service provider licensee to consumers due to breach of set standards and examine and decide on customer complaints. In addition, it shall be entitled to provide instructions as to a specific transaction with an essential service provider licensee, if a relevant directive is stipulated by the Minister.
4. Granting licenses and supervising the compliance with the licenses' provisions
As for the decisions of the Electricity Authority resulting from the above, see Note 3 below.

e. The principal directives for fixing the rates are as follows:

1. The Electricity Authority will fix rates based on the cost model taking into consideration, among others, the type and level of services and will include a fair rate of return on capital. The Law did not define a fair rate of return.
2. In fixing rates, the Electricity Authority may choose not to take into consideration all or some of the expenses which it believes are irrelevant to fulfilling the duties of the essential service provider licensee.
3. Every rate will reflect the cost of a certain service without subtracting one price at the expense of raising another price.
4. The rates will be updated according to an update formula determined by the Electricity Authority. The update formula will include recognized allowable required costs, a fair rate of return on capital and, after consulting with the ministers, might bring into account an efficiency coefficient.

On September 12, 2004, in the framework of the Company's appeal against the Electricity Authority, the Supreme Court determined, among others, that the consideration regarding maintaining the Company's financial solvency, although it constitutes a relevant consideration in determining the electricity rates, expresses only one aspect of the public interest over which the Electricity Authority is charged with pursuant to the Electricity Sector Law.

In exercising its authority pursuant to the law, the Electricity Authority must include in the quorum of its considerations, an entire composite of considerations that were intended to result in "the arrangement of the activities in the Electricity Sector for the public interest, while assuring availability, quality, efficiency, all of which while creating conditions for competition and minimization of costs".

f. The Electricity Sector Law, as it was amended in March 2005, determines that the Minister is entitled, if he saw that the matter is required in order to advance the objectives of the Law and the Government's policy or his policy in the Electricity Sector, to instruct the Electricity Authority to grant a license, to change the terms of a license, to add to or detract from the terms of a license (or from arguments that will be recorded, after he has heard the Electricity Authority's position on the matter, and after he has given notice to the Government of that), the Minister has instructed, as aforesaid, the Electricity Authority will carry out his directive within the period of time he determined. If 21 days have elapsed from the date on which the Minister gave his notice to the Government and no written demand was made by a member of the Government to discuss the notice, the Minister's instruction will be viewed as being in force. In addition, it was prescribed by the law, as amended, that various obligations to report to the Minister are imposed on the Electricity Authority.

Further, if the Minister shall see that the Electricity Authority is no acting properly in accordance with the provisions of the Electricity Sector Law, he is authorized to disband it, if within a reasonable period of time that will be determined it did not fulfill what was imposed on it (in consultation with the Minister of Finance and approved by the Government). Within 30 days from the disbanding of the Electricity Authority, a new Authority will be appointed, and until then the Authority will continue operating in its previous composition.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

3. Below are additional provisions included in the Electricity Sector Law (cont.)

g. An essential services provider license will not be granted except to a company that will undertake that it will only engage in activities pursuant to the licenses that were granted to it pursuant to this law and related activities. The holder of an essential service provider license is entitled to engage in other activities, which were approved for him by the Ministers in consultation with the Electricity Authority, where there is nothing in being engaged in them that would impair his activities or the regulation of his fulfilling his obligations pursuant to the Electricity Sector Law.

h. The Electricity Sector Law stipulates that if a license granted by law has been cancelled, conditioned or amended fro reasons stated in section 8 to the Electricity Sector Law (Government Policy Regarding the Electricity Sector, the Contribution to the Level of Services to the Public, the Good of the Consumers and Competition), the Ministers may determine criteria for granting compensation to the license holder but it is possible that based on the above criteria, the compensation rate will be zero.
The Company's management estimates that in view of the fact that both the Company's development activities and the pledges on the Company's assets created to secure its liabilities are approved by the Minister, then if damage is caused to the Company as a result of the above, it shall be compensated according to generally accepted principles, pursuant to established rules, although no notice in this matter has been delivered by the Government.

i. The Control of Prices of Goods and Services Law, 1996 ("the Control Law") also applies to the electricity rates. The Control Law authorizes the Ministers to apply the provisions of this Law in accordance with the criteria as detailed therein, including the determination of prices, price increases and the level of the control on these commodities and services. The Company believes, based on the opinion of its legal advisers in spite of the fact that as a rule the determination of electricity rates will generally be carried out by the Electricity Authority, intervention by the Ministers is likely, by force of the Control Law, in the event that the Israeli market faces extreme situations, such as high inflation or the threat thereof. Pursuant to the notice from the Companies Authority to the Company, the Electricity Authority is the only party authorized to determine electricity rates.

4. The assets acquisition

a. With respect to certain rights and assets, which were held by the Company on the eve of the replacement of the Electricity Concession Ordinance by the Electricity Sector Law, the following provisions were determined in the Electricity Sector Law (section 62):

1) In spite of the provisions of section 46 to the amendment to the Electricity Concession Ordinance ("section 46 to the concession"), the liabilities of the Company, as well as its rights and assets which it held at the time the Concession expired, and for which it is entitled to compensation from the State pursuant to the aforesaid section, will remain with the Company and no compensation will be paid for them.

2) The rights and assets for which the Company is not entitled to compensation, as stated above in section 1, and which are used or were designated to be used, whether directly or indirectly, for its operations pursuant to this law, will be purchased by the Company according to their value on the date the rights and assets were acquired, in accordance with an arrangement to be signed by the State and the Electric Corporation; in this section "are used" or "were designated to be used", as will be determined by the ministers.

3) Until the arrangement referred to above in section 2 is carried out, the assets and rights, in respect to which the arrangement is being settled, will remain with the Company, as they were at the time the Concession expired. If the parties do not arrive at the aforesaid arrangement within one year from the date the Concession expires, the ministers will determine provisions with respect to the acquisition of the aforesaid rights and assets.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

4. The assets acquisition (cont.)

b. In the first year following the date on which the Concession expired, no negotiations were held and, in any case, the parties did not reach a arrangement and, as of the date on which the financial statements were signed, the ministers had not determined the assets that are used or are intended to be used by the Company and/or any provisions with respect to the acquisition of the aforesaid rights and assets (hereinafter- the "assets acquisition").

c. The law does not detail which assets will be included under section a.1 above (hereinafter: "the compensable assets") which, according to the provisions of the Electricity Sector Law, remain with the Company, and, in accordance with the Electricity Sector Law, it is not required to pay the State for them; or, under section a.2 above (hereinafter: "the non-compensable assets") in respect of which, as stated, the assets acquisition is to be settled. In addition, the Electricity Sector Law does not define the method pursuant to which the value of these assets will be determined.

d. Section 62 to the Electricity Sector Law refers to section 46 to the Concession. Section 46 to the Concession in its updated version, following the correction of the Concession in 1970, which was titled "Expiration of Concession" determines as follows:
"At the expiration of the Concession the undertaking together with all fittings accessories and stores shall pass into the ownership of the High Commissioner free of charge subject to the payment by him of adequate compensation for any supplies of fuel materials apparatus meters and instruments in stock or in transport or on order belonging to and/or paid for by the Company.
Should the Company in the meantime have set up any laboratory or other scientific establishment or established a library and should the High Commissioner take over such establishment and/or library, the High Commissioner shall pay adequate compensation therefore.
However: The Company shall be entitled to claim adequate compensation for installations and repairs in the conditions determined in section 44(c), as if the Government acquired the undertaking on the date on which the undertaking was passed into the Government's ownership.
The provisions of section 44(f) to the Amendment of the Electricity Concession Ordinance (hereinafter: "section 44(f) of the Concession") will apply, with the required changes as applicable, as if the Government had acquired the undertaking on the aforesaid date."

e. Section 44(c) of the amendment to the Electricity Concession Ordinance (hereinafter - "Section 44 (c) of the Concession") in its updated version prescribes: The Government shall also pay to the Company adequate compensation for each one of the installations it established and the repairs made, other than repairs required by ordinary wear and tear, prior to the date of the purchase, all of which if all of these were met and, in the event they were met:
The installation or the repair was not written-off pursuant to the provisions of the second amendment to the Concession.
The payment for the installation and the repair was not from a debt deriving from a debenture or from the capital of a loan that were not paid yet, and that the Government will be obligated to repay them pursuant to the provision of subsection (c).
The payment for the installation or repair was not made from share capital or by someone interested in a connection, as implied in the concession amendment deed."

f. Section 44(f) of the Concession prescribes the following:
"If at the date of such purchase there shall be outstanding any Debenture or other loan capital of the Company authorized under Clause 38 hereof, the High Commissioner shall take over the liabilities of the Company in respect thereof, but shall be entitled to the benefit of any existing funds for the amortization of the same".

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

4. The assets acquisition (cont.)

g. The Company believes, based on the opinion of its legal advisors regarding the matter of the appropriate interpretation of the assets acquisition, and taking into consideration the provisions mentioned above with respect to the amendment to the Electricity Concession Ordinance, pursuant to which, the majority of the assets held by the Company when the Concession expired (both fully depreciated depreciable assets and depreciable assets which were not fully depreciated at the time the Concession expired, and excluding assets at a marginal scope), are compensable assets and, therefore, they are not supposed to be included in the assets acquisition, and also, to the implementation of the assets acquisition there was not supposed to be, there is not and will not be a material effect on the Company or its financial position, although the matter is to be studied and determined by a government team that was appointed in order to determine the implementation of the Company's restructuring, and, therefore, there is no certainty that the implementation of the assets acquisition will not have such an effect.

h. On February 15, 2000, the Company received a letter from the Deputy Commissioner of Budgets at the Ministry of Finance wherein he indicates that as part of the activities of the Governmental team that was appointed to deal with the asset acquisition issue, an economic, accounting and legal opinion was prepared (and was attached to the letter to the Company), (hereinafter - "the Economic Opinion") the implementation of this opinion might have a material effect on the Company.

   According to the Economic Opinion which refers to the provisions of section 46 to the Concession, the Company was entitled to compensation in respect to items of inventory that were ordered by it and for which it paid, in respect to certain assets, subject to the conditions detailed in the provisions of section 44(c) to the Concession:

   1) The assets were not fully depreciated - in the Economic Opinion it was claimed that this condition is not only applicable to the fully depreciated assets, but that it also restricts the Company's right to compensation in respect to assets which were only partially depreciated, which is, in view of the double stipulation, required at the beginning of section 44(c) to the Concession: "if all of these were met and in the event they will be met...", the Company was entitled to compensation primarily because of the depreciable assets which were not fully depreciated, for the balance which was not yet written off.
   2) Those assets whose acquisition was financed by liabilities which the Government will be obligated to repay - in the Economic Opinion, it was stated that, in this connection, it is prepared to accept the position presented in the Opinion, pursuant to which this condition is irrelevant in view of the fact that under the provisions of the Electricity Sector Law (section 62(a)), the liabilities which were supposed to be transferred to the State at the end of the Concession remained at the Company
   3) The payment for the assets was not financed by share capital or payments which the Company received for any connection to the electricity grid - in the Economic Opinion, the argument which is detailed in the Opinion, is rejected pursuant to which, this condition is irrelevant, where the rationale and economic logic for this, in their opinion, is that compensation will not be made to the shareholders in respect to the assets which were not financed by the owners' sources, and this in spite of the almost absolute identity which currently exists between the "shareholders" and the "sovereign".
      1) All of the Company's assets which at the time the Concession expires were fully depreciated, and this is because of the fact that the investments in respect to them were recognized in the rate through the provisions for depreciation (power plants, transmission and distribution facilities, real estate properties and various assets such as equipment, machinery and various buildings).
      2) Assets which were not fully depreciated, in the amount of what was depreciated net of liabilities, according to a certain percentage which depends on their financing sources - primarily power plants, transmission and distribution facilities, certain real estate and additional equipment.
      3) The Company's non-depreciable assets - primarily intangible assets and shares of investee companies, but not cash and inventory.

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

4. The assets acquisition (cont.)

In the Economic Opinion, criteria were determined for classifying the assets, as aforesaid and, in addition, formulae were determined for calculating the value of the purchase, which are based on the economic value of the assets and the liabilities. There are no data in the Economic Opinion with respect to the economic value or the method for determining it. The cost, as of March 1, 1996, of the assets which were fully depreciated, as detailed in section 1 above, as it appears in the Company's financial statements at that time, is approximately NIS 4.46 billion (approximately NIS 6 billion in NIS of December 2006). The net depreciated cost, as of March 31, 1996, in the Company's books, of the assets detailed in sections 2 and 3 above, is approximately NIS 4.5 billion (approximately NIS 6 billion in NIS of December 2006).

In the Company's opinion, one should not infer the economic value of the assets from the amounts indicated above where pursuant to this economic value, the amount which the Company is liable to be requested to pay will be determined, even if the position proposed in the Economic is accepted.

i. Just after the Economic Opinion was received, the Director of the Electricity Authority in the Ministry of National Infrastructures (hereinafter: "the Director") wrote a letter to the Company, as instructed by the Minister. In the letter, he instructed the Company not to respond to the Ministry of Finance's approach with regard to the matter of the assets acquisition, as long as the matter had not been discussed in an orderly manner between the Offices of the Ministers and between the Company and the Ministry of National Infrastructures.

j. The Company is of the opinion, based on the opinion of its legal advisors, that the interpretation of section 62 to the Electricity Sector Law in a manner which will obligate the Company for the payment of the above amounts or any similar amount, in order to purchase the assets from the Government, will be contrary to the declared purposes and objectives of the Electricity Sector Law, contrary to the principles of the appropriate interpretation and will constitute an impairment of the proprietary rights of the Company, in contrast with the basic law: Man's dignity and freedom. This is due to the impairment which will arise for the Company's shareholders' equity, the possibility of acceleration of the Company's loans, the doubt as to its ability to repay its liabilities and to continue operating as a going concern, while the explicit intention of the legislator was that the Company will exist and fulfill the functions it was assigned and the tasks imposed upon it in the Electricity Sector Law and the licenses granted to it by virtue thereof.

   In addition, the acceptance of the aforesaid interpretation, and assuming that the purchase cost needs to be recognized in the electricity rate (see section k. below) will obligate the electricity consumers to pay an additional time for the assets, the purchase of which by the Company, was already paid for in the past by the consumers through the electricity rate.

k. The Company is of the opinion, based on the opinion of its legal advisors, that the cost for the Company, if there will be in respect to the assets acquisition or in respect to the acquisition provisions from the ministers, needs to be recognized in the electricity rate base, although there is no certainty of this. The Electricity Authority did not express an opinion on the matter, and there is no reference to this aspect in the Ministry of Finance's Opinion.

l. The Accountant General at the Ministry of Finance indicated on several occasions that several assets held by the Company have been transferred to the State pursuant to the Electricity Sector Law. The Company is of the opinion, based on the opinion of its legal advisors, that pursuant to the Electricity Sector Law, the Accountant General is not authorized to determine the matter of the ownership of these assets and, in addition,

m. Certain assets, which, on the eve of the replacement of the Electricity Concession Ordinance by the Electricity Sector Law, were held and which are not used in, and are not intended to be used in, the Company's operations according to the Electricity Sector Law and which, according to the Company's position, based on the opinion of its legal advisors, are not subject to the assets acquisition, it is likely that they will not continue to be owned by the Company. The position presented in the Ministry of Finance's

Note 1: The Legal Environment in which the Company Operates (cont.)

a. The Electricity Sector Law and the amendments thereto

4. The assets acquisition (cont.)

Opinion, assumed that these assets were transferred to the State. The Company's policy was and is to purchase assets, which are designated to be used in the Company's operations to produce and transmit electricity. Therefore, in the Company's opinion, if the aforesaid assets were indeed held, the number of them is small and their economic value to the Company is marginal. No notice was given by the Ministers regarding this matter (see l. above).

n. On the basis of all of the above, the Company, based on the opinion it obtained, believes that the implementation of the assets acquisition was not supposed to have, does not have and will not have a material effect on the Company or its financial position, although the matter is subject to the examination and determination of the general directors team and, therefore, there is no certainty that the implementation of the assets acquisition will not have this effect.

5. If the State is required to make any payment with respect to the Company's liabilities which were in effect when the Concession expired, due to its expiration or as a result of the assets acquisition referred to in section 3 above, the Company will indemnify it for any such payment.

b. Licenses and regulations pursuant to the Electricity Sector Law

1. On September 2, 1997, regulations under the Electricity Sector Law were adopted (Conditions and Procedures for the Granting of a License and the Obligations of the Licensee), 1997, which determine, among other things, the procedures and conditions that the party requesting a license must comply with in order to be eligible to receive a license, including conditions regarding shareholders' equity, internal sources of financing and related matters.

The regulations also provide that the Minister may condition the granting of a license as a supplier of an essential service upon the organizational and legal structure of the party requesting a license or upon such party providing a commitment to change the aforementioned structure. In addition, the Minister may direct that a change in the organizational and legal structure be carried out during the term of the license. The Minister may not, however, direct such a change during the period in which the initial transmission license is valid.

2. The Company has a license for transmission, as well as separate generation licenses for the various generation units (hereinafter "the generation licenses"). In addition, the Minister determined, pursuant to the Electricity Sector Law, that since a material share of the generation in the electricity sector is concentrated in the Company, the provisions of the Electricity Sector Law apply to it, which refer to the supplier of an essential service. All of the licenses are valid through July 1, 2007.

The Company estimates that there is no guarantee that at the end of the maximal period for extending the generation licenses without executing the outlined restructuring stipulated by law (November 1, 2007), the Company will be granted licenses (fully or partially) or that there will not be a change in the terms of the licenses compared to the existing licenses (in whole or in part) (see also Note 1.a. above regarding the restructuring).

3. Subsequent to the amendment of the Electricity Sector Law of March 2003, which imposed restrictions on granting generation licenses, the Company completed the construction of five generating units (gas turbines at the Eshkol, Gezer - 2 turbines, Alon Tavor and Zafit sites), whose construction commenced prior to March 4, 2007. These generating units' installed capacity reaches about 11.7% of the Company's total installed generation capacity as of December 31, 2006.

In order to obtain licenses for these generating units, the Company had to incorporate them as subsidiaries. Due to employee sanctions, the Company was unable to do so and consequently, it did not receive licenses for said units.

Note 1: The Legal Environment in which the Company Operates (cont.)

b. Licenses and regulations pursuant to the Electricity Sector Law (cont.)

Under Amendment No. 5 to the Electricity Sector Law, it was determined that the Electricity Authority, as approved by the Minister, is entitled to grant generation licenses to these generating units until July 1, 2007, with a possibility for extension until November 1, 2007, even if they are not incorporated as subsidiaries as required by the Electricity Sector Law. In the context of the employee sanctions in protest of the approval of the amendment to the Electricity Sector Law of February 2007, the workers committee instructed the employees not to cooperate with anything that has to do with licenses and therefore, the Company is unable to apply for the required generation licenses (see Note 21.c below).
Until such licenses are received, the Company has decided to continue the upkeep of the new generating units in order to maintain their operational capability according to the manufacturer's instructions and beyond that, operate them during emergencies when there is real concern of damaging the vital sector needs or when facing a real threat to human life. The Company has notified the Minister and the Attorney General of its decision to be implemented as long as the latter do not see it fit to apply Section 58 to the Law whereby the Minister is authorized to declare and determine provisions that will apply to the sector's operations during emergencies or provide the Company with other instructions or directives, as approved by the Government.

4. The Electricity Sector Law imposes sanctions on anyone who operates units for generating electricity without a license as specified below:

- Criminal sanctions - Pursuant to section 52 (a) of the Electricity Sector Law, carrying out activities in the electricity generation sector (or any other activities in the electricity sector that requires licensing) without a license constitutes a criminal offense the law for which, regarding the Company, there are penalties. In addition, the law prescribes that an executive who does not monitor and do everything possible to impede violations of the law by the company or one of its employees - the penalty in his case is one-year imprisonment and a fine.
- Cancellation of licenses - Section 3 of the Electricity Sector Law prescribes that: "No one will perform activities (including the generation of electricity) except pursuant to a license from the Minister pursuant to this law." In addition, that "if a license is granted, the holder of the license will act in accordance with the conditions of his license." According to the licenses held by the Company, the Company must act in accordance with the provisions of the law, including any law that came into force subsequent to the granting of the licenses (such as, the amendment to the law that prescribed the new policy in the sector of granting of the licenses in the electricity sector). Violation of the law constitutes a violation of the licenses, and the Minister is entitled to cancel the licenses if he finds that any of their conditions were violated (such as the violation of the law, as stated above).
  According to the accounting principles for regulated companies, a regulated company must amortize the amount of the investment in fixed assets that, most probably will not be recognized for it for purposes of the rate. As of the balance sheet date, the Company's investment in power stations for which construction has ended, but which are inactive due to the fact that they were not granted operating licenses because they were not incorporated as subsidiaries (five stations at the Alon Tavor, Gezer and Zafit sites), in the amount of about NIS 1,817 million, and the investment in power stations for which construction had not yet ended as of the balance sheet date amounts to about NIS 4,741 million. The Company estimates that the issue will be resolved and settled with the restructuring (see a. above) and accordingly, no provisions was recorded in respect of this issue.

5. The generation and transmission licenses which have been granted provide, among other things, that:

- All of the Company's activities will be carried out as separate profit centers and certain activities may be carried out in more than one profit center. The profit centers are set forth in an appendix to the license. This appendix was not attached to the generation licenses.
- The license holder will submit separate audited annual financial statements for each area, activity, generation unit or power plant and for each profit center (regarding generation licenses, as the Director will direct, and regarding the transmission license, as the Minister will direct from time to time), and will also submit

Note 1: The Legal Environment in which the Company Operates (cont.)

b. Licenses and regulations pursuant to the Electricity Sector Law (cont.)

5. The generation and transmission licenses which have been granted provide, among other things, that: (cont.)

consolidated financial statements regarding its activities based on all the licenses it holds. If the holder of a generation license is holding another license or other licenses for additional activities, financial statements will be submitted as described above also in respect of those activities, as the Minister may direct.

- The license holder will submit a business plan to the Director, including pro forma financial statements audited by the auditors of the license holder, regarding its activities pursuant to the license for the entire period of the license. The license holder will update the plan each year and will present the updated plan to the Director. The financial statements will be prepared separately for each area, activity, generation unit or power plant and profit center (regarding generation licenses, as the Director will direct, and regarding the transmission license, as the Minister will direct from time to time).
- The Company, while ensuring reliability and efficiency and without discrimination, will carry out the activities and services.
- A license holder may carry out the activities which are ancillary to those activities performed pursuant to the license, as described in the appendix to the license. Ancillary activities not included in the appendix must be approved by the Minister.
- The generation licenses provide that a generation unit must be available for the generation of electricity in accordance with the operation and maintenance program to be filed by the Company and approved by the Director.
- A development program (see section a.3 above) as well as a business plan shall be submitted to the Minister.
- The transmission license requires the holder to provide infrastructure and backup services to other license holders, and the holder is required to purchase electricity from independent power producers (see section a.3 above).
- Pledging, transferring or foreclosing the assets specified in the licenses (which include substantially all of the Company's assets) is prohibited, except as permitted by the Minister (see section a.3 above). In addition, the transmission license prescribes that the Minister is entitled to add to or remove from the list of assets in the appendix to the license, during the term of the license.
- The direct or indirect inclusion of or reference to an asset in the licenses or their appendices will not be deemed to grant the license holder any rights in the asset with respect to the assets agreement (see section a.4 above).
- There shall be no change or reorganization in the owner of the license, including by merging, splitting, compromising, entering into an arrangement or a voluntary liquidation, without the Minister's authorization.
- The Minister may at any time cancel a license, in its entirety or partially, or suspend a license or add or change general conditions and general obligations thereof if he discovers that a condition of the license was breached or that one of the restrictions contained therein has been breached or that the holder of the license is no longer qualified to hold the license as required by the Electricity Sector Law and its regulations. The generation licenses further provide that the Minister may act as aforesaid for the reasons specified in Section 8 of the Electricity Sector Law (it should be pointed out that section 9(a) to the amendment to the Electricity Sector Law from 2005 prescribed that in general the aforesaid authority was shifted to the Electricity Authority.
- A generation license fee shall be paid by the holder at a rate to be determined by the Ministers.
- If the State is required to make any payment in respect of an action or omission of the license holder in respect of its activities pursuant to the license, the license holder will indemnify the State.

The Company's management believes that, except for what is stated below, the Company is in compliance with the terms of the licenses that were granted.

The Company does not file audited financial statements for the profit centers, as required in the licenses. The Company intended to make arrangements for the preparation of financial statements per area of activity, as required by the provisions of the Companies Authority since the Company believes that such implementation will meet the requirements of the licenses. Due to sanctions initiated by the Company's employees in that respect, the Company did not file the above financial statements.

Note 1: The Legal Environment in which the Company Operates (cont.)

b. Licenses and regulations pursuant to the Electricity Sector Law (cont.)

5. The generation and transmission licenses which have been granted provide, among other things, that: (cont.)
Despite the above, the Company estimates that the requirement to file audited financial statements for the profit centers will not have a material effect on it, although there can be no certainty of that and although no notification was received from the Director in that respect.

c. The Government Companies Law

1. Pursuant to the Government Companies Law, a Government company is defined as a company where in excess of half of the voting rights at general meetings or the right to appoint more than half of its directors are held by the State, or are held by the State together with a Government company or a Government subsidiary. Since the State of Israel holds 99.8% of the Company's share capital, pursuant to this law the Company is defined as a Government company.

2. The Government Companies Law prescribes, among others, as follows:

a. The decision by a Government company to sell shares that it holds in its Government subsidiary requires Government approval and the approval of the Knesset's finance committee.

b. Decisions by a Government company in these matters require Government approval:

(1) Changes in the company's objectives.
(2) Increase in the authorized share capital.
(3) Changes in the rights attached to the shares.
(4) Allocation of the company's shares or the agreement to transfer shares when called according to the founding documents - if this involves something that can result in a material change in the balance of power between the members of the company or that can provide a new member 10% or more of the par value of the share capital or the voting rights in the company or the right to appoint a director.
(5) Issuance of redeemable Preferred shares.
(6) Issuance of convertible debentures, and the conversion into shares of debentures issued without the right of conversion or a loan received by the company.
(7) Changing the company from a company that is not private to a private company or from a private company to one that is not private.
(8) The reorganization of the company, its voluntary dissolution, compromise, arrangement or merger with another company.
(9) The establishment of a company, single-handedly or with others, and the purchase of shares in an existing company.
(10) A right granted by a company or a commitment a company assumed where it is possible that it could, directly or indirectly, restrict the Government, whether in its Governmental function or in its position as a shareholder in the company, including in connection with carrying structural changes and privatization, promoting competition and regulating the sector in which the Company operates. In this respect, "right or commitment" - including a right or commitment and pursuant to which an act or omission on the part of the Government, not under the Company's control, will provide a third party with relief and remedies against the Company.
(11) A public offering of securities pursuant to a prospectus, if the Companies Authority assumes that as a result of the publication of a prospectus that the State, being the controlling shareholder in the Company, will be responsible for any damage that will be caused by a misleading detail in the prospectus, pursuant to the Securities Law, 1968 ("the Securities Law"), and so informed the Company.
(12) An act as a shareholder in a Government subsidiary in one of the matters stated above in sections (1) through (10).
(13) A commitment to one of the acts stated above in sections (1) through (11).

Note 1: The Legal Environment in which the Company Operates (cont.)

c. The Government Companies Law (cont.)

2. **The Government Companies Law prescribes, among others, as follows: (cont.)**
   c. The Minister of Finance is entitled, pursuant to the recommendation of the Companies Authority, to determine regulations for the preparation of the budgets and plans, whether for all Government companies or for certain categories.
   d. A Government company will operate according to the commercial considerations by which a non-Government company operates, except if the Government has determined for it, with the approval of the Knesset's finance committee, other options for carrying out its operations. The Company has always acted in this manner and the State of Israel has never instructed the Company to utilize other options. However, the Government has the power to instruct the Company to take certain actions, including such that will cause the sale of some of its assets, subject to obtaining the proper approvals.
   e. In addition to the provisions of any law, the Minister of Finance, in consultation with the Minister of Justice, and with respect to a public company - in consultation with the Securities Authority, is entitled to determine according to the recommendation of the Companies Authority, rules for the preparation of a Government company's financial statements that, with respect to which, he determined that it is supplying the public with an essential service, including with respect to the details to be included in them, the accounting principles to be applied in their preparation, and the declarations and notes that they will include.
   f. Should the Companies Authority feel that the public interest so requires, it is entitled to instruct a Government company as to the manner in which to present details in its financial statements, or in any other report that the company is required to file pursuant to any law, provided that the instructions in this regard were not determined in the rules, law or generally accepted accounting principles and by generally accepted reporting principles.
   g. If the Companies Authority disputes the manner in which details are presented in the financial statements or any other report that the Government company is required to file pursuant to all laws, it is entitled, if it feels that the public interest so requires, to instruct the company to disclose the position of the Companies Authority and to describe the dispute in the financial statements to the satisfaction of the Companies Authority.

3. In respect of the aforesaid in sections 2.e through 2.g, the Companies Authority approached the Company with various requests for the disclosure of additional information in the financial statements, as detailed below (see also Note 2.a.3.):
   a. In March 2004, the Companies Authority instructed the Company that, pursuant to section 33.b of the Government Companies Law, disclosure should be provided in the Company's financial statements regarding the activities segments for the generation, transmission and distribution of electricity. The disclosure will include condensed balance sheets, statements of operations and the principal details that were used in the preparation of the activities segments. Disclosure will also be made for the financial targets, including targets for achievement of the normative costs determined by the Electricity Authority, and the differences between them and the effective costs.
   b. On September 14, 2004, a directive was issued to the Company ("the directive") by the Companies Authority, in accordance with its authority in section 33.b of the Government Companies Law, as follows:
      1. The Company's licenses, rates, activities, its regulation and the decisions by the State and its authorities relate to each activity of the Company separately. The Israel Electric Corporation Ltd. is a complex company with an enormous scope of activities that provides a service to the public. In view of the short timetable for completing the carrying out of the numerous and complicated preparations required until the beginning of 2006, the date for the end of the licenses and current rate basis, disclosure is required as detailed in this directive. The accounting preparations and the disclosure made in the financial statements concerning the Company's activities constitute an important phase for the purpose of full disclosure and meeting the timetables. Providing this disclosure in the financial statements is essential to fulfilling the duties of transparency, full disclosure and fulfilling the duties of providing an account and accountability, while creating controls and reporting mechanisms that are essential to the Board of Directors, the Company's management, the shareholders and the others using the financial statements.

Note 1: The Legal Environment in which the Company Operates (cont.)

c. The Government Companies Law (cont.)

3. In respect of the aforesaid in sections 2.e through 2.g, the Companies Authority approached the Company with various requests for the disclosure of additional information in the financial statements, as detailed below (see also Note 2.a.3.): (Cont.)

2. The disclosure will be provided based on the principles regarding the recording of the transactions concerning the various activities and will include, among others, comparative data, including, as stated below, financial statements of the various activities, details of the assumptions, the main details and the accounting principles used in their preparation.
   The calculation of the rates for the various activities will be in accordance with the principles that were (or will be) prescribed by the Electricity Authority (regarding this issue).
3. The activities' disclosure will be provided for the activities that are detailed in section 5 below, and will be included in all of the annual and quarterly financial statements and the budgets (annual and multi-annual), that will be filed on a current basis by the Company, in accordance with the principles and the details including in the provisions of the Authority's circulars and as detailed below.
4. In the financial statements for the second quarter of 2005 and thereafter, the aforesaid disclosure will, in addition, include in the Note the following details:
   a) Financial statements of generation units to which section 6(g) to the Electricity Sector Law applies.
   b) Financial statements of activities at the sites: Rutenberg and Orot Rabin.
   c) Financial statements of the transmission segment.
   d) Financial statements of the distribution segment according to the details of section 8 below.
5. Below are details of the activities:
   a) The distribution segments: the Northern district, Haifa district, Jerusalem district, Dan district and the Southern district - each separately.
   b) The generation segments: Rutenberg site, Orot Rabin site, Haifa site, Reading site, Eshkol site, Gezer site, Hagit site, Alon Tavor site. Ramat Hovav site, Zafit site and the other sites as one additional generation site - each separately.
   c) The transmission segment.

c. In January 2005, the Company decided to organize itself in order to enable the preparation of separate financial statements for each activity as required by the directives of the Companies Authority in section 4 above in the directive ("separate financial statements"), where the work plan includes, among others, preparation of methodology, work procedures, internal controls procedures, as well as a computerized solution. Performing the work in accordance with this decision was postponed due to the sanctions taken by the employees that prevented the implementation of the decision.
   On March 26, 2006, the Company received a letter from the Director of the Companies Authority where the latter announces that the implementation of the preliminary milestones that are scheduled to be completed by March 26, 2006 is deferred by at least one more quarter. Until the date of signing the financial statements, there have been no further developments in the matter.
   As stated in Note 2.a.3, implementing the directives of the Companies Authority for disclosure of the Company's activities constitutes a condition in the regulation enacted by the Minister of Finance for preparing adjusted financial statements beginning as of January 1, 2004 through December 31, 2007 (see also Note 3.c. below). In addition to this, exclusion of the information required pursuant to the law from the financial statements is liable to result in an impairment of the Company's ability to publish financial statements.

Note 1: The Legal Environment in which the Company Operates (cont.)

d. Government decisions regarding the Electricity Sector Law

Over the years, Israel's various Governments made decisions that concern the Electricity Sector, their principal elements of which are:

1. **Decision dated May 28, 1995** (and subsequent decisions from August 13, 1997 and from November 4, 2002)
To open the electricity generation sector to independent power producers for 20% of the generation of electricity.
As of the date on which these Financial Statements were signed, the scope of the installed electricity generation capability for independent power producers comprises about 0.7% of the Company's total installed electricity generation capability. Nonetheless, to the best of the Company's knowledge, additional conditional approvals in principal were granted to independent producers at an aggregate scope of between about 2,060 megawatts and about 2,705 megawatts that, as of the date on which these financial statements were signed, comprise between nearly 19% and nearly 25% of the installed electricity generation capability of the Company.
Should the entrepreneurs comply with the conditions of the Electricity Sector Law and the timetables set up for them, on the dates of the aforesaid commercial operation they will be provided with independent electricity producer licenses. These projects are at the stage of the examination of applicability, and initial examinations were performed at the Company regarding the ways to link them to the Company's transmission web; however, as of the date on which the financial statements were signed, the Company has not yet signed agreements with these entrepreneurs, and a specific timetable for links to the Company's transmission web was not even set up.

2. **Decision dated August 13, 1997**
To adopt the principles of the policy appearing below in the electricity generation sector.
    - Independent power producers will be permitted to sell electricity directly to final customers, while using the transmission services of the national and regional grids.
    - Tenders to independent power producers will be made and published by the Government.

3. **Decision dated August 12, 1998**
    - To act in a manner that will promote the Government's policy to integrate independent power producers into the electricity sector.
    - To enable the sale of electricity in bulk to malls and office buildings while making the adjustments required by law, by rules and regulations.
    - To prescribe Government policies, pursuant to the Electricity Sector Law, such that additional parties will be able to engage in the distribution of and/or trade in electricity and to act toward arranging the terms of the transactions between the essential service license holders.

4. **Decision dated March 11, 2002**

    To encourage the establishment and operation of power and heat facilities (hereinafter: "co-generation facilities") for the generation of electricity by independent power producers. Transmission of electricity from the co-generation facility will be done primarily through the Company's transmission grid. It was also determined in the decision that generation by co-generation will not be included in the generation quota intended for independent producers (20% of the generation of electricity).
    The Electricity Sector Regulations (Transactions with the Holder of an Essential Service Provider License), 2000, will apply to sales to the holder of an essential services provider license. The method of the sale will be according to the method for the sale of energy, or the available supply and energy, as defined in the electricity sector regulations.

Note 1: The Legal Environment in which the Company Operates (cont.)

d. Government decisions regarding the Electricity Sector Law (cont.)

5. Decision dated November 4, 2002

Independent power producers who are interested in selling electricity to parties other than the Company, will be able to obtain a license to produce electricity privately, without a tender, in accordance with the conditions that will be determined by the Minister. This is on condition that the plans will be approved pursuant to the Planning and Building Law. In the framework of the conditions, the Minister will be able to determine that transactions for the purchase of electricity between the Company and the holder of a private producer license can only be possible on the basis of the free will of the parties.

Generation by independent power producers, who received generation licenses, as stated above, will not be included in the generation quota designated for independent power producers within the borders of Israel.

6. Decision dated September 12, 2006

The structure of the electricity sector and the Company's structure will be changed as described below, and insofar as it will be required, the Electricity Sector Law will be changed:

a) The Company will be a Government owned holding company ("the holding company"). Companies will be spun-off from the holding company in the generation, distribution and transmission of electricity sectors and the management of a system and companies in the sectors for additional services as detailed below.

b) The Company's management, and the Company's entire operations sector that will not be incorporated separately, as detailed below, will remain a part of the holding company.

<u>Electricity generation</u>

c) The generation of electricity will be based on four subsidiaries, where each company will have a coal basis and additional units, in the profile of similar fuel consumption. Additional coal-powered generation units that will be established will be the basis for additional generation companies, or will be added to the aforesaid four companies.

d) Each generation company can also be engaged in the sale of electricity to end consumers (supply of electricity).

e) These generation companies will be incorporated as subsidiaries of the holding company by March 1, 2007.

f) By January 1, 2012, the holding percentage of the holding company in each of the generation companies declined to 51%, including through issuances to the public.

g) In the framework of the reduction in the holding company's holding percentage, as stated in section f, the employees will be entitled to compensation from the holding company or from the generation companies, as applicable, in accordance with employee compensation procedures in the Companies Authority's privatization. In addition, the employees will be eligible to compete for the purchase of additional holdings in these companies at equal terms.

h) Once competition is established, the generation and supply segment will progressively exit the Electricity Authority's rates regulation.

i) The ministers will be entitled to approve the sale of holdings in the generation companies exceeding what is stated in section f. In the absence of agreement between the ministers, the Prime Minister will resolve the matter, without derogating from the provisions of the Government Companies Law.

j) Upon the sale of 49% of the holding company's holdings in the generation company, this company will be authorized to engage in desalination. This activity will be carried out pursuant to the principles of the arrangement customary in those segments.

<u>Electricity transmission and system management</u>

k) Commencing March 1, 2007, the transmission and system management company will be operated, the function of which will be to operate and development the electricity transmission network. A profit center will be set up in that company separate from the transmission activities that will be involved in system management, long-range planning of the electricity system and the management of the commerce in electricity. This profit center will have authorities opposite the companies operating the electricity sector,

Note 1: The Legal Environment in which the Company Operates (cont.)

d. Government decisions regarding the Electricity Sector Law (cont.)

6. Decision dated September 12, 2006 (cont.)

in a manner that, among others, will guarantee the level of development and maintenance required in the electricity sector under Government supervision. The activities of the transmission and system management company will be performed under supervision, including the rate for supplying transmission services. Thereafter, the need for creating a separate company for managing the system and commerce will be studied.

l) The transmission and system management company will be obligated to provide services at terms that are equal to those of all parties in the electricity sector.

m) The transmission rates will be bound to a fair rate of return on capital for the purpose of the financial stability of the transmission and system management company.

Electricity distribution

n) The Company's distribution segment will be split into four separate distribution companies that, from the aspect of the costs structure, will be similar and, insofar as is possible, will be similar in size.

o) These distribution companies will be incorporated as subsidiaries of the holding company by March 1, 2007.

p) By January 1, 2012, the holding company's holding percentage in each of the distribution companies will decline to 51%, including the manner for issuances to the public.

q) In the framework of the reduction in the holding company's holding percentage, as stated in section p., the employees will be entitled to compensation from the holding company or from the distribution companies, as applicable, in accordance with employee compensation procedures in the Companies Authority's privatization. In addition, the employees will be eligible to compete for the purchase of additional holdings in these companies at equal terms.

r) The ministers will be entitled to approve the sale of holdings in the generation companies exceeding what is stated in section p. In the absence of agreement between the ministers, the Prime Minister will resolve the matter, without derogating from the provisions of the Government Companies Law.

s) The distribution companies will act to operate and develop the existing regional electricity grid, and it will be operated under regulation, including the rate for transmission service.

t) The transmission companies will be obligated to provide services at terms that are equal to those of all parties in the electricity sector.

u) The distribution rates will be bound to a suitable rate of return on capital for the purpose of the financial stability of the companies.

Additional services

v) Until March 1, 2007, the Company's planning, construction and performance, information technologies and logistics divisions will operate as separate divisions in the framework of holding companies.

w) By January 1, 2009, each of the divisions will be incorporated as separate subsidiaries under a "holding company".

x) By January 1, 2012, the holding company's holding percentage in each of the service companies will decline to 51%, including the manner for issuances to the public.

y) Subsequent to January 2012, all of the holding company's holdings in each of the service companies will be sold.

z) In the framework of the reduction in the holding company's holding percentage, as stated in sections 24 and 25, the employees will be entitled to compensation from the holding company or from the additional service companies, as applicable, in accordance with employee compensation procedures in the Companies Authority's privatization. In addition, the employees will be eligible to compete for the purchase of additional holdings in these companies at equal terms.

Note 1: The Legal Environment in which the Company Operates (cont.)

d. Government decisions regarding the Electricity Sector Law (cont.)

6. Decision dated September 12, 2006 (cont.)

aa) The ministers will be empowered to prescribe in the regulations, in spite of the provisions of the Mandatory Tenders Law, that the generation, distribution and transmission companies that were spun-off from the Company will give preference to commitments with service companies, for periods and at terms that will be determined by the ministers. Further, these companies will also be entitled to compete on other tenders outside of the electricity sector.

bb) Upon the sale of 49% of the holding company's holdings in the distribution and generation companies, the holding company will be allowed to establish subsidiaries that will be involved in other activities segments. These activities will be carried out pursuant to the arrangement procedures customary in these sectors.

cc) To empower the representatives of the Companies Authority, the budget division at the Ministry of Finance and the Ministry of National Infrastructure to negotiate with Company's management and the representative employees organization concerning the change in the electricity sector's structure and in the Company's structure.. The agreements to be reached by the parties in the context of these negotiations will be presented for approval by the ministerial committee for social and economic affairs, to the degree that it will be required in order to amend the Electricity Sector Law.

dd) To establish a team that will include representatives from the Companies Authority, the budget division at the Ministry of Finance, the supervisor of the payroll division at the Ministry of Finance, the Ministry of National Infrastructures and the Company's management to negotiate with the Company's representative employees organization, regarding employee rights in the context of the structural change. The recognized costs for the change in structure will be expressed in future electricity rates.

e. The Payment of Dividends

The Government Companies Law prescribes that the decision by the Board of Directors regarding the designation of the Company's earnings, including with regard to a distribution as it is defined in the Companies Law, requires the approval of the Companies Authority. If the Companies Authority differs with the Board of Directors' decision, then a company of the Company's type (as long as it is not a company in privatization) will act pursuant to the Electricity Authority's decision (as the Government approved it).
The present policy of the Companies Authority (which may change from time to time) concerning the designation of profits for the payments of dividends from 1995 and thereafter, determines:

1. In Public Utilities Companies, the dividend from current profits will be at a rate of 60% of the annual current net income before bonus payments to the employees from such profits.

2. The dividend from accumulated profits will be determined specifically for every company, taking into consideration relevant data and factors.

The provision for the dividend was recorded in light of the provisions of section 3 of the Companies Authority circular, 97/1-2c, dated February 9, 1997, and the clarifications of the Companies Authority, pursuant to which when the dividend is recorded, reference should be made to the net income and all of its components, prior to the payment of a bonus to the employees out of the earnings.

According to an opinion from the Company's attorneys, there is nothing in the above entry that derogates from or impairs the position of the Board of Directors with respect to the actual distribution.

The Company's Board of Directors is of the opinion that according to criteria in section 302 of the Government Companies Law and the Authority's circulars, it would be appropriate to determine the amount of the distributable dividend solely according to the criteria that are indicated in the Companies Law.

Note 1: The Legal Environment in which the Company Operates (cont.)

f. Restrictive Trade Practices

On January 5, 1999, the Restrictive Trade Practices Commissioner ("the Commissioner") by force of his authority pursuant to the Restrictive Trade Practices Law, 1988 ("the restrictive law") declared that the Company has a "monopoly" in the electricity supply sector (the generation and sale of electricity), the transmission and distribution of electricity and the provision of back up services to consumers and producers of electricity. There is nothing in the declaration in and of itself in order to change the Company's status as having a monopoly, or to apply obligations to it.

The statutory tools prescribed in the restrictive trade practices law grant the Commissioner, inter alia, the right to require submitting new standard form contracts for his approval and entitles him to intervene in those matters likely to injure the public, including the right to apply to the Court to divide the monopoly into two or more separate business entities.
On May 4, 1999, the Company filed an appeal with the Antitrust Tribunal, subsequent to which the Company reached an agreement with the Commissioner, which received validity as a ruling, as follows:

1. The Company is a monopoly in the electricity sector that includes, among others, the following components: the supply of electricity - the generation of electricity and its sale, the transmission of electricity and its distribution, providing backup services to electricity consumers and its producers.

2. The provisions of chapter d of the Restrictive Trade Practices Law apply to the Company as the owner of a monopoly, both in the electricity sector in general, and in respect to each of its components.

As of the date on which the financial statements were signed, the declaration of the Company being a monopoly did not have a material effect on its operations, profitability or financial position. In light of the existing degree of supervision by the Electricity Authority and other authorities or which the Company is subject and in view of the structural changes required pursuant to the provisions of the Electricity Sector Law, including the incorporation of the generation units in the framework of separate subsidiaries, the Company is unable to assess what would be the future implications of the aforesaid declaration on the Company's operations, profitability and financial position, although it is possible that there will be material implications.
In addition to the above, the Company is subject to a composite of the provisions of the restrictive trade practices law, including with respect to restrictive arrangements and mergers. It should be pointed out that, by force of the Company being a monopoly, its merger with any company whatsoever, is subject to the provisions of the restrictive trade practices law regarding the merger of companies. The Company is implementing an internal enforcement program with regard to anti-trust activities.

g. Environmental quality

The Company's activities are subject to the environmental laws and regulations in respect to various matters such as air pollution, water resources, noise, storage, freight and disposal of poisonous waste, dangerous materials and others. A substantial part of these existing environmental laws and regulations were legislated in the past while others are in various stages of development. The Company expects that the current environmental laws and regulations are liable to be even more stringent in the future and that new laws will be adopted.

The Company believes (subject to the following information regarding non-ionizing radiation) that it is complying with all the requirements of the current environmental laws and regulations, and has appropriated funds to its capital investment plan and its operating budget in order that it will be able to comply with the current and anticipated rules and regulations. However, there is no guarantee that the costs and liabilities in the framework of current and expected laws will not exceed the funds appropriated by the Company; however, even then at immaterial amounts.

Note 1: The Legal Environment in which the Company Operates (cont.)

g. Environmental quality (cont.)

On January 1, 2006, the Non-Ionizing Radiation Law, 2006 was published in the official government gazette ("the Law"). The Law is also applicable to power plants used for electricity generation, transmission, distribution and supply up to the home distribution stage. The Law prescribes that a radiation installation is not to be constructed or operated unless by a special approval of the radiation supervisor in the Ministry of the Environment. The Law stipulates that building permits for radiation installations can only be obtained by first obtaining radiation permits. The Law entitles the radiation supervisor at the Ministry of the Environment broad authorities such as: cancelling a permit or stipulating conditions in its respect; authorized entrance to locations with radiation sources; appointing supervisors; possible granting of an order to dispose of an installation; notifying the public of the existence of radiation sources and their location etc. The Law is effective as of January 1, 2007 with reference to new electric installations (electric installations for which a building permit or license had not been received by January 1, 2007) and as of July 15, 2008 with reference to existing installations. The Law constitutes a "framework law", which means that it prescribes taking "preventive precautionary measures" but does not stipulate what measures or determine the obligatory threshold values. It should be noted that pursuant to the Non-Ionizing Radiation Law, decisions, as well as regulations, which have a material effect on the electricity network, must be accepted under the consent of the ministers.

The Company is also acting to obtain permits for its electricity installations. The subject has not yet been settled with the Ministry of the Environment and there are certain disputes between the parties. As long as permits are not obtained, the Company will not be able to construct new installations that had not been granted a building permit or license by the end of 2006.

Based on the Company's calculations and tests for various power lines and transformation installations, the Company believes that as a rule, it is complying with the directives of the International Commission on Non-Ionizing Radiation Protection.

Following the determination of the International Agency for Cancer Research, in August 2001, the radiation supervisor at the Ministry of the Environment issued a recommendation whereby electricity installations will be planned and operated in such a manner that the population will not be exposed to a magnetic field exceeding an average of 10 milligauss ("mG") a day, in addition to the maximum value of 1,000 mG, which is the maximum value for a magnetic field.

The Ministry of the Environment provided guidelines for those who address it that are also embedded into measurement reports conducted by the Ministry and by private surveyors. According to these guidelines, the threshold value of 1,000 mG is foe a short period of time only whereas prolonged exposure to over 2 mG is a potential cause of cancer, yet the average levels in Israeli living rooms do not exceed 0.4 mG. Such statements raise claims and arguments against the Company on the part of the public and government authorities. Moreover, several zoning authorities have incorporated a condition in the building permits regarding electricity installations according to which the installation's magnetic field levels must not exceed 2 mG. The inclusion of the above condition prevents the Company from connecting installations to the electricity network. The Company has submitted its reservations to this stance to the Ministry of the Environment and the Ministry of National Infrastructures and has argued that the above guidelines are interpreted by both the public and by some of the government authorities as a binding standard which the Company is unable to meet. This issue has not yet been settled between the government offices and the Company.

With respect to the magnetic field requirements, several claims have been filed against the Company at courts of law, certain of which have been stricken or rejected and certain are pending. The Company is studying the economic, legal, operational and technical ramifications of the above. The Company estimates that the costs that will be incurred as a result of subsequent adjustments for complying with the provisions of the Law and/or regulations will be covered by the electricity rates.

Note 2: Significant Accounting Policies

a. General

1. The Company presents its financial statements in accordance with Israeli Securities Regulations (Preparation of Annual Financial Statements) - 1993 (as amended) and in accordance with Israeli generally accepted accounting principles, except as stated in section (3) below.

2. The Electricity Law prescribes that a holder of a license to supply an essential service shall prepare its financial reports as determined by the Ministers in consultation with the Minister of Justice with regard to their details, the accounting principles applied in their preparation, and the declarations and notes attached. Such directives and obligations applicable to the Company's financial statements as of December 31, 2006, have not yet been determined by the Ministers (See also Note 1.b.2 above).

3. In accordance with section 33.a of the Government Companies Law (see Note 1.c above), the Minister of Finance, in consultation with the Minister of Justice, and with reference to a public company in consultation with the Securities Authority, is entitled to determine according to the recommendation of the Companies Authority regulations for the preparation of a Government company's financial statements that, in regarding which, he determined that it provides an essential service to the public. This includes the matter of the details the financial statements will include, the accounting principles for their preparation, and the declarations and notes to be attached to them.

On September 14, 2004, the Minister of Finance enacted the Government Companies Regulations (Principles for the Preparation of Financial Statements of the Israel Electric Corporation Ltd.) (Temporary Order), 2004, which is in accordance with his authority pursuant to the aforesaid law. Under these regulations, it was determined that during the period commencing January 1, 2004 and ending December 31, 2005 ("the transition period"), the Company will prepare its financial statements adjusted for the changes in the general purchasing power of the NIS, in accordance with principles prescribed in Opinion No. 36, including the provisions that were prescribed in Opinions Nos. 40, 50 and 56 of the Institute of Certified Public Accountants in Israel.

The notes to these financial statements will include the details of the disclosure of the Company's operations, which is required in accordance with the directives of the Companies Authority pursuant to section 33.b to the Government Companies Law, which were given to the Company on March 2, 2004 and on September 14, 2004 (see Note 1.d.3 above), as well as the additional provisions according to section 33.b to the aforesaid, concerning the Company's operations, as they will be given from time to time ("the Companies Authority directives"), provided that the Companies Authority has found that the Company implemented its directives. Should the Company not implement the Companies Authority directives, the Company shall not prepare its financial statements where they are prepared adjusted for the changes in the purchasing power of the NIS.

On June 12, 2006, the Minister of Finance enacted regulations that extend the above transition period until December 31, 2007 and, in addition, the following regulations were prescribed:

a) "The Company will prepare for the transition to reporting in accordance with International Accounting Standards, will report on that, as required in the Authority's circulars, and will submit draft financial statements to the Companies Authority for the period commencing January 1, 2007 and ending June 30, 2007. In those financial statements, subject to the directives of the Authority, it will implement International Accounting Standards in accordance with the decision of the professional committee of the Israel Accounting Standards Board dated November 15, 2005, or in accordance with the detailed standard that the aforesaid Institute will promulgate. Attached to the draft will be an opinion of the auditor that will include information in accordance with the Authority's requirement".

b) "Should the Company not complete the preparation for the transition to reporting in accordance with International Accounting Standards by August 31, 2007, the Company will not prepare, during the transition period, the financial statements as of September 30, 2007 and thereafter in accordance with the directives that were prescribed in the opinion".

With respect to the effect of the aforesaid regulations on the financial statements, see Note 3.b.9 below.

Note 2: Significant Accounting Policies (cont.)

a. General (cont.)

4. In accordance with section 33.b of the Government Companies Law, in the event the Companies Authority will see that the public interest requires this, firstly it will instruct the Government company as to how to present items in the financial statements, or in any other report that the Company is required to file pursuant to any law, provided that the directives in this respect did not prescribe principles, by law or in generally accepted accounting principles and in generally accepted reporting principles. Regarding the Electricity Authority's directives deriving from the aforesaid, see Note 1.c.3.a above, and section ee. below.

b. Accounting for the Effects of the Electricity Authority's Regulation

The Company's rates are determined in accordance with the decisions reached by a public regulatory authority - the Electricity Authority (see Note 1.a.3 above). In Israel, special accounting principles regarding companies of this nature ("regulated companies") have not yet been determined and, accordingly, the Company applies the standard of the Financial Accounting Standards Board in the U.S., Standard No. 71, which deals with accounting for the effects of certain types of regulation (hereinafter, "the Standard").

The objective of the Standard is to establish and define how to apply generally accepted accounting principles to regulated companies and how to reflect the decisions of the regulating authority in the financial statements of those companies. The Standard allows, upon certain criteria being met, an accounting policy which is different from what is commonly practiced regarding the timing for carrying income and expenses to the statement of operations, the objective of which is to reflect and devise adequate matching between the expenses and revenues that will result to the Company according to the dates on which they will be recognized in the electricity rate. In addition, the Standard prescribes regulations concerning the impairment of the value of assets that is measured according to the future cash flow, which is based on the electricity rate as the Electricity Authority determined it. These regulations are different from the regulations that apply to an unregulated company.

The Standard is applied when the following three cumulative criteria exist:

1. Rate regulation - the rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

2. A specific cover for costs - the regulated rates are designed to recover the specific costs (including the required return on capital) of providing the regulated services or products.

3. Competition and the likelihood for collection from customers in view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the costs can be charged to and collected from customers.
These criteria may also be applied to separable portions of a utility's business, such as the generation of electricity, or its transmission, or to a specific class of customers.
A company meeting the above criteria will capitalize costs that would otherwise be recorded as expenses if rate action of the regulator makes it probable that those costs will be recovered in future revenue. The aforesaid capitalized expense is a regulatory asset. In addition, such a company could also record regulatory liabilities, according to the circumstances.
The Standard requires that rate-regulated companies reassess the probability of recovering their regulatory assets at each balance sheet date. If a company concludes that it is no longer meeting the above three criteria, or that the recovery of a regulatory asset, or a portion thereof, is no longer probable, then the regulatory asset or a portion thereof, must be removed from the company's balance sheet.
With respect to the Company meeting the criteria of the Standard, see Note 3.c.2 below.

Note 2: Significant Accounting Policies (cont.)

c. Definitions

1. **Affiliated Company** - a company over which the Company has significant influence and that is not consolidated, and the investment in which is included in the Company's financial statements on the equity basis.

2. **Investee Company** - a consolidated or an affiliated company.

3. **Controlling Inte**rests - according to the definition in the Israeli Securities Regulations (Presentation of Transactions between a Corporation and a Controlling Interests Therein in the Financial Statements), 1996.

4. **Interested Parties** - according to the definition in the Israeli Securities Regulations (Preparation of Annual Financial Statements) - 1993.

5. **Related Parties** - according to the Statement of Opinion No. 29 of the Institute of Certified Public Accountants in Israel.

6. **$** - U.S. Dollar

7. **CPI** - Consumer Price Index published by the Central Bureau of Statistics in Israel.

8. **CPI for a specific month** - The CPI relevant to a specific month which is published during the following month.

9. **CPI known on a specific day** - the latest known CPI on any day during a specific month.

10. **The Basket of Currencies** - a basket of currencies, the composition of which is determined by the Bank of Israel.

d. Price level adjustments

1. As stated above in section a, the Company prepares its financial statements on the basis of historical cost, adjusted for changes in the general purchasing power of the new Israeli shekel ("NIS"). The nominal financial statements that form the basis on which the adjusted statements were prepared appear in Note 30.

2. The adjusted values of non-monetary assets do not necessarily represent the market value of these assets or their value to the Company, but only their cost adjusted for changes in the general purchasing power of the NIS.

3. In the adjusted statements, the term "Cost" shall be deemed to mean "Adjusted Cost".

4. The comparative figures in these financial statements are presented in Adjusted NIS of December 2006 purchasing power.

Note 2: Significant Accounting Policies (cont.)

d. Price level adjustments (cont.)

5. The following are the CPI, Exchange Rates of the NIS/Dollar and the NIS/Basket of Currencies and the rates of change thereof for the periods indicated:

	Consumer Price Index*		Exchange rate of the U.S. dollar on the balance sheet date	Exchange rate of the Basket of Currencies on the balance sheet date
	For the month of the balance sheet	On the date of the balance sheet		
	Points	Points	NIS	NIS
December 31, 2003	178.58	178.94	4.379	4.9646
December 31, 2004	180.74	180.56	4.308	5.0061
December 31, 2005	185.05	185.41	4.603	5.0891
December 31, 2006	184.87	184.87	4.225	4.8253
Rates of change during the accounting period %	%	%	%	
For the year ended December 31, 2004	1.21	0.91	(1.62)	0.84
For the year ended December 31, 2005	2.38	2.69	6.85	1.66
For the year ended December 31, 2006	(0.1)	(0.29)	(8.21)	(5.18)

* The index on an average basis of 1993 = 100.

e. Principles used for the adjustments

1. Balance Sheet

a) The amounts for the non-monetary items (items for which the amounts appearing in the balance sheet reflect their historical values when purchased or incurred) are adjusted according to the changes in the CPI from the month in which each transaction was carried out to the CPI for December 2006.
The following items were treated as non-monetary items: fixed assets and accumulated depreciation thereon, issuance costs, inventory, prepaid expenses, receipts and disbursements for unfinished contracts, perpetual debentures, capital reserves and share capital.

b) The equity of the investments in investee companies is determined on the basis of the adjusted financial statements of those companies.

c) Monetary items (those items for which the amounts appearing in the balance sheet reflect their adjusted or realizable values as of balance sheet date) are presented in the adjusted balance sheet as of December 31, 2006, in amounts similar to their nominal amounts as of that date (the comparative numbers were adjusted to NIS of December 2006).

2. Statement of Income

a) The statement of income items (except financial expenses) which express transactions carried out during the reported year - income, expenses, etc. - were adjusted according to the changes in the CPI from the month in which they were carried out through December 2006. The erosion in monetary balances connected to those transactions, are included in the financial expenses, net item.

b) The statement of income items related to non-monetary items (such as depreciation and amortization, changes in inventory, prepaid expenses and revenues collected in advance) have been adjusted on the same basis as the related balance sheet items.

c) The statement of income items related to provisions and accruals included in the balance sheet (such as accruals for pension and severance expenses and vacation pay, etc.) are determined on the basis of the changes in the balances of the relevant balance sheet items after taking into account the cash flows in their respect.

Note 2: Significant Accounting Policies (cont.)

e. Principles used for the adjustments (cont.)

2. Statement of Income (cont.)

d) The equity in the results of operations of investee companies is determined based on the adjusted financial statements of those companies.

e) The net financial item reflects real financial income and expense, as well as the erosion of monetary balances during the year.

3. Statements of Changes in Shareholders' Equity

A dividend declared and paid during a reported year is adjusted according to the CPI in effect at the actual date of payment. A dividend proposed as of the date of approval of these financial statements and which is to be distributed from the earnings for the reported year and, as of the balance sheet date, has not been paid, is included without adjustment.

The amount presented as purchasing power gain represents the erosion in the real value of the dividend proposed in prior years that was paid, in practice, in the following year (the erosion relates to the adjustment from the beginning of the year and until the actual date of payment).

f. Cash equivalents

Cash equivalents are considered by the Company to be highly liquid investments that include short-term bank deposits with maturities not exceeding three months from the investment date and are not restricted by a charge.

g. Short-term investments

Short-term bank deposits are deposits purchased with original maturities of more than three months.

h. Customer discounts

Current customer discounts are recognized in the financial statements upon receipt and are carried to revenues.

i. Allowance for doubtful accounts

The financial statements include an allowance for debts for which collection is doubtful based on information available regarding the financial position of the consumers and on a statistical analysis of the consumers' debt balance.

j. Inventory - coal and fuel oil

Inventory is valued at the lower of adjusted cost, determined by the adjusted moving average method, or market price to the extent that it affects the electricity rate. As for Accounting Standard No. 26 regarding Inventories, see aa.3 below.

Inventory of coal purchased by the National Coal Company ("National Coal") (a subsidiary of the Company) for the Company from various foreign suppliers was recorded in the Company's books as inventories in transit (see Note 7).

k. Inventory - stores

The inventory is valued according to the cost determined by the adjusted moving average method.

Note 2: Significant Accounting Policies (cont.)

l. Investments in investee companies

1. Investments in the Company's affiliated companies are included on the basis of the equity method of accounting.

2. The Company recognizes losses of affiliated companies in excess of its equity investment if the Company has an obligation to fund such losses of affiliated companies.

3. The Company does not consolidate its financial statements with those of the Coal Company because of the lack of materiality.

m. Investments in debentures

Permanent investments in marketable securities are presented at market value, which management believes are not of a temporary nature.

n. Fixed assets

1. The Company capitalizes all costs related to construction of fixed assets to fixed assets under construction (including, inter alia, direct salaries and related expenses, materials, sub-contractors and overhead), as well as real financial expenses incurred prior to such assets being placed in service. (See section v.5. below).

2. Depreciation is calculated by the straight-line method, based on the estimated economic life of the assets, as follows:

	Estimated Economic Life (in years)
Power plants	30-50 (Primarily 30 years)
Industrial gas turbines	25
Jet gas turbines	15
Transmission system	30
Distribution system	20-30 (Primarily 30 years)
Meters	14
Equipment, office furniture, mobile mechanical equipment and telecommunications	10
Computers and ancillary equipment*	3-12
Motor vehicles	5-7
Buildings	30

Additions to the existing generating systems are depreciated over the remaining period of depreciation of the original cost of such systems.

* Includes key software for which the date of their initial operation was in 2005 and thereafter, and for which their economic life is 12 years.

3. Customer payments for the coverage of the costs of the establishment of the transmission and the distribution system are depreciated over the useful lives of the related payments.

4. Spare parts for power plants and motor vehicles are amortized in accordance with their attribution.

5. **Standard No. 15:** This Standard deals with the impairment of assets, and is based on International Accounting Standard No. 36 (the corresponding U.S. Standard, that deals with this issue, is SFAS 144). It prescribes the accounting principles in the case of impairment/elimination of the impairment of the Company's assets (primarily fixed assets), including investments in investee companies that are not subsidiaries, goodwill arising from the acquisition of subsidiaries and fair value adjustments.

Note 2: Significant Accounting Policies (cont.)

n. Fixed assets (cont.)

Since the Company is a regulated company that applies SFAS 71 to the fixed assets used in the regulated activities, there are different regulations with respect to the examination of the impairment of assets that were determined by SFAS 71 and SFAS 90 (see section b above).

The U.S. Standard SFAS 144 that deals with the impairment of assets prescribes that it does not apply to fixed assets to which the regulations of SFAS 90 apply, which deals with regulated companies.
In the Company's opinion, so long as it is complying with the regulations for the application of SFAS 71, Standard 15 does not apply to it.
The Electricity Authority, pursuant to the Electricity Sector Law, determines the electricity rates based on the Company's costs. In addition, the Electricity Authority determined the required return on the capital according to its evaluation of the Company's cost of capital. Therefore, when there is a rate mechanism that provides the Company with full coverage of its costs and, in addition, leads the Company to profitability at a level that, according to an economic analysis of the electricity web, constitutes a suitable return on capital (both shareholders' equity and foreign capital), and should the discount rate that is to be performed according to Standard 15 will be similar to the price for the capital that the Electricity Authority determines in the rate, then it is reasonable to assume that it is not necessary to record a provision in accordance with Standard 15 if it were applicable.

Should the Company reach the conclusion that it is no longer complying with the principles for applying SFAS 71 (for example, in the event that it no longer foresees income at the required level of return on the capital), it is likely that there will also be a need to record a provision for an impairment of value of the assets pursuant to Standard 15 (see Note 3.c.2 below).

6. Assets leased under a capital lease are presented in the framework of fixed assets based on the current value of the future lease fees. The future lease fees, net of the interest component imbedded in them, are included under long-term liabilities.

7. The Company carries out connections to homes and increases in existing connections. The surplus (lack) of expenses, in excess of the receipts from those ordering the jobs, is credited to or debited from, as applicable, fixed assets at the end of the connection jobs. Until the jobs are ended, the surplus of receipts from those ordering the jobs, net of the expenses in respect to the jobs in progress are recorded in the framework of the item, advances from those ordering jobs, net of jobs in progress.

o. Dividend declared subsequent to balance sheet date

Dividend that is declared subsequent to the balance sheet date and prior to the signing of the financial statements is not recorded as a liability in the financial statements and is presented in the financial statements as a separate item in the statement of changes in shareholders' equity.

p. Deferred taxes

Except as described in Note 19.j.4, the Company records deferred taxes using the liability method, at the enacted tax rates that will apply when the deferred taxes or benefits are expected to be realized. The deferred taxes, net, are classified into current assets or liabilities and long-term assets or liabilities, according to their expected time of utilization.

The deferred tax liability includes a liability in respect of the adjustment to the Israeli Consumer Price Index of depreciable assets that are non-deductible for tax purposes (except for immaterial buildings), whose depreciation is carried over at least 20 years from their initial operation. The Company is of the opinion that the accounting

Note 2: Significant Accounting Policies (cont.)

p. Deferred taxes (cont.)

treatment as above is required in order to create an adequate correlation between carrying the depreciation in respect of these assets and their respective tax expenses.

The taxes that would have applied in the event the investments in investees were realized were not taken into account in the calculation of the deferred taxes, as long as it is more likely than not that the investments in the investees are not expected to be sold in the foreseeable future.
In addition, the deferred taxes in respect to the distribution of earnings by investees through dividends were not taken into account, since the distribution of a dividend does not involve an additional tax liability.

q. Spreading of actuarial gains and losses according to the principles of international accounting standard no. 19

In the absence of a specific accounting standard in Israel that addresses the treatment of actuarial income/losses that accumulated during the reported (“actuarial changes”), the Company decided to apply the distribution principles in accordance with International Standard 19, “Benefits to Employees”.
The Company distributes the accumulated actuarial changes during the reported period to the wage and pension costs, by amortizing them to the wage and pension costs over 15 years (a period that does not exceed the expected average term of employment for the employees).

Such, the amounts of the expenses that are carried to the salary and pension costs are the amount of the calculated interest at the beginning of the reported period in respect to liabilities for that date (“interest on obligation”), as well as the expected return on plan assets amount in respect to the entitlement that accrued from the addition of seniority during the reported period (“current service cost”), less expected interest rate as well as in respect to the funded amounts as of the beginning of the reported period.

Actuarial changes deriving primarily from the difference between the actuarial assumptions, that are long-term assumptions, and the behavior of those variables during the reported year (such as, the expected rate of increase in salaries, the capitalization interest rate, the rates of early retirement and mortality and from the difference between the effective return on the funded amounts during the reported year, and the expected return at the beginning of the year) and from the changes in the actuarial assumptions themselves, (regarding the change in the actuarial assumptions during the reported year, see Note 17.a.1.b).

In light of the increasing scopes of the actuarial changes and their material effect over the last few years on the Company’s financial results, and in light of the Electricity Authority’s position in its letter to the Securities Authority dated March 10, 2005, in which it notified that it recognizes the Company’s pension expenses as an integral part of its operating expenses, based on normative annual expenses, implying that the spreading of the pension expenses is the most efficient method for ensuring controls for the Company’s costs to maintain a stable rate for the benefit of the entire economy, and in light of the spreading approach that is expected to be implemented in the pension fund sector (as emerges from the letter from the Securities Authority to the Company dated March 15, 2005), the Company assumes that the implementation of such an accounting policy will result in a more proper allocation of the actuarial changes.

r. Liability for vacation pay

The liability with respect to the redemption and utilization of vacation days accumulated by the employees is calculated based on their salaries in the month of the balance sheet and is classified as either a short-term or long-term liability in accordance with its expected utilization.

Note 2: Significant Accounting Policies (cont.)

s. Revenue recognition

1. On January 1, 2006, the Company adopted the provisions of Accounting Standard No. 25 regarding revenues ("the Standard"). The Standard deals with the recognition of revenue from three types of transactions: sale of goods, rendering of services and revenue from interest, royalties and dividends and prescribes the required accounting treatment regarding these three types of transactions.

The initial adoption of the Standard had no material impact on the financial statements.

2. Revenues from the sales of electricity are included upon the consumption of electricity by the customers according to meter readings. The revenues in respect to the amount consumed, in the period between the last meter reading and the balance sheet date, are included according to estimates.

3. Revenues from interest are accrued in a timely manner, taking into consideration the principal for repayment.

t. Research and development

1. Research and development costs are charged to the statement of income as incurred.

2. As for the disclosure of the effect of Accounting Standard No. 30 in the period prior to its adoption, see section aa below.

u. Debt issuance and related costs, premium and discounts

Until December 31, 2005, deferred charges in respect of the issuance of debentures and loans were presented in other assets at cost less accumulated amortization. Expenses attributed to raising debentures were amortized using the straight-line method over the period of the loans.
As of January 1, 2006, with the application of Accounting Standard No. 22, "Financial Instruments: Disclosure and Presentation", the cost of issuing debentures is offset from the outstanding liability in respect of the debentures and is amortized to profit and loss systematically over the term of the liability. This amortization is not essentially different from the effective interest method (* prescribed by Standard No. 22.
(* the effective interest method is a method for computing the amortized cost of a financial instrument and of the attribution of interest income or expense over the relevant period. The effective interest rate is the rate that accurately discounts the expected flow of future cash payments or receipts over the expected life of the financial instrument or a shorter period, if appropriate.
The change in amortization method as above had no material impact on the Company's financial position and results of operations.

v. Financial instruments and financial expenses, net

1. On January 1, 2006 ("the effective date"), the Company adopted the provisions of Accounting Standard No. 22, "Financial Instruments: Disclosure and Presentation" ("the Standard") of the Israel Accounting Standards Board. The Standard prescribes principles for the presentation and disclosure of financial instruments and supersedes Opinions No. 48 and 53 of the Institute of Certified Public Accountants in Israel. In accordance with the provisions, the Standard is being applied prospectively and comparative data have not been restated or reclassified.

Note 2: Significant Accounting Policies (cont.)

v. Financial instruments and financial expenses, net (cont.)

The principal changes promulgated by the Standard in contrast to the principles applied prior to January 1, 2006 are: transaction costs in respect of a financial liability are deducted from the liability and are taken into account in the computation of the effective interest rate; upon the issuance of several types of financial instruments in a single unit (shares, debentures and warrants), the components of the unit, including related transaction costs, are classified separately upon initial recognition into the various financial instruments based on their fair value; compound financial instruments that include both a liability and an equity component (such as convertible debentures) are bifurcated between the equity component (receipts from conversion option) and the liability component and each component is classified separately (net of transaction costs attributed to the different components).

2. Currency swap and forward transactions for the hedging of accounting exposure

It is the Company's practice to utilize swap transactions in order to convert a portion of the exposure of its liabilities denominated in U.S. dollars to the exposure to the CPI or the change in the exchange rates of other currencies in order to adjust them to its electricity rate.

The Company reflects in the balance sheet only the net balance of swap transactions as of the balance sheet date. According to their book value this balance is presented as part of the loans when it is in credit, and in long-term receivables when it is in debit (see Notes 8 and 18).

The results of currency swap transactions are charged to the foreign exchange gain/loss component of financial expenses and offset the foreign exchange gain/loss related to the long-term loans that they hedge (see Note 28).

3. Forward transactions to hedge the cash flows

The results of forward transactions that are carried out by the Company are presented at their value on the balance sheet date, and charged to financial expenses (income).

4. Swap transactions of fixed interest rates on loans to floating interest rates and floating interest rates in respect to fixed interest loans

These transactions are presented at their cost as of balance sheet date, and the results are carried to financial expenses (income).

5. Capitalization of financial expenses

The Company applies Accounting Standard No.3 with regard to the capitalization of financial expenses. The costs of specific liabilities incurred in respect of the investment in qualifying assets, as defined by this Standard, were capitalized to this investment. The capitalization of financial expenses for investing in qualifying assets, which were not financed by specific liabilities, is calculated by using a percentage which is the weighted average of the rates for financial expenses, in respect to the Company's non-specific liabilities (see Note 28.a), during the reported period, the Company does not capitalize its unspecific credit costs beyond the amount of the costs of these credit costs.

In addition, according to the decisions of the Electricity Authority, the Company capitalizes financial expenses in respect to assets used in constructing the fixed assets (see also Note 3 below).

6. Fair value of financial instruments

The fair value of the financial instruments traded in active markets is based on the quoted market prices as of balance sheet date. The fair value of financial instruments that are not traded in an active market is based on market prices of similar financial instruments and, if none available, on other methods of evaluation.

The Company uses various evaluation techniques accompanied by assumptions that are based on the prevailing economic conditions at each balance sheet date.

The evaluation methods used include the current value of cash flows, economic option pricing models and other standard evaluation methods. See also Note 23 below.

Note 2: Significant Accounting Policies (cont.)

v. Financial instruments and financial expenses, net (cont.)

7. Offsetting financial instruments

Financial assets and liabilities are presented in the balance sheet in their net amounts only when the Company has a legal enforceable offset right and the intent to settle the asset and liability simultaneously.

8. Perpetual debentures

The Company issued perpetual debentures to the State of Israel, valued at about NIS 15 million, which were included until December 31, 2005 in the Company's shareholders' equity at an adjusted value of about NIS 2 billion, and in respect to which interest and linkage differences on the interest were paid, in an amount aggregating to about NIS 100 million per annum.

Pursuant to the provisions of Standard 22, it is necessary to classify these perpetual debentures, at their adjusted value, as a liability, and the interest in their respect as financial expenses in the statement of operations (see y. below).

w. Presentation of transactions between a corporation and a controlling interest therein:

The transactions between the Company and its controlling interest are presented in accordance with the Securities Regulations (Presentation of Transactions Between a corporation and a Controlling Interest Therein in the Financial Statements), 1996. Accordingly, the difference between the proceeds that were received from the controlling interest in respect to the transfer of the asset to the controlling interest, and the book value of the asset in the Company's books is carried to the Company's shareholders' equity (see Note 13 below).

x. Earnings per share

Following the cancellation of Opinion 55 regarding earnings per share and the cancellation of Regulation 64(c) to the Securities Regulations (Preparation of Annual Financial Statements), 1993, companies whose Ordinary shares or potential Ordinary shares are not listed for trade or are in the process of being listed for trade on public markets are not required to provide a disclosure of earnings per share. Due to the above cancellations, no earnings per share were disclosed in these financial statements.

y. Reclassification

Certain data previously published in the financial statements as of December 31, 2004 and 2005 have been reclassified to conform to the current presentation in the financial statements as of December 31, 2006.

In 2006 (January 1), Accounting Standard No. 22 came into effect. The Standard's main impact on the Company's financial statements was a change in the classification of perpetual debentures (whose adjusted value in the books approximates NIS 2 billion) from equity to a liability and carrying the interest in respect of these debentures to financial expenses rather than a deduction from shareholders' equity as before. Consequently, on January 1, 2006, these perpetual debentures were reclassified from shareholders' equity to very long-term liabilities and financial expenses in respect of perpetual debentures were recorded in financial expenses. In addition, expenses relating to issuances of debentures were reclassified from other asses to long-term liabilities.

z. The use of estimates

When preparing the financial statements in accordance with generally accepted accounting principles, management of the Company is required to use estimates and assumptions which affect the amount of the assets and the liabilities as of the date of the financial statements, the presentations of assets and contingent liabilities as of the date of the financial statements and the amount of revenues and expenses for the period of the financial statements. Actual results are liable to be different from these estimates.

Note 2: Significant Accounting Policies (cont.)

aa. The effect of the new accounting standards during the period prior to their implementation

1. **Accounting Standard No. 16 - Investment Property:**
In February 2007, the Israel Accounting Standards Board published Accounting Standard No. 16, "Investment Property" ("the Standard") that prescribes the accounting treatment and disclosure requirements for investment property.
An investment property is property (land or a building or part of a building or both) held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both.
Examples of investment properties include land held for long-term capital appreciation and not for short-term sale in the ordinary course of business; land held for a currently undetermined future use (if the use of the land as owner-occupied property or as held for short-term sale in the ordinary course of business has not yet been determined, the land will be regarded as held for capital appreciation); a building owned by the entity (or held under a finance lease) and leased under an operating lease; a vacant building that is held to be leased under an operating lease.
Investment property is to be presented using the cost model or the fair value model. According to the cost model, investment property is accounted for pursuant to the cost model in Accounting Standard No. 27, "Fixed Assets". Companies that choose to adopt the cost model are required to disclose the fair value of the investment property. In contrast, under the fair value model, changes in the fair value of an investment property are recognized in the income statement in the period in which they arise. Investment property that is accounted for under the fair value model is not depreciated.
Property held by a lessee under an operating lease may be considered investment property if, and only if, the property would have otherwise met the definition of investment property and the lessee is using the fair value model prescribed by the Standard (regarding the lease as a finance lease). If the property under operating lease is accounted for as investment property, all properties held by the entity that are classified as investment properties must be accounted for using the fair value model.
In respect of properties that comprise a portion that is held to earn rentals or for capital appreciation and another portion that is held for owner-occupied use, each portion is accounted for separately only if each portion can be sold separately. Otherwise, the property is accounted for as investment property only if the portion held for owner-occupied use is insignificant.
The Standard is applicable to financial statements for periods commencing on January 1, 2007 or thereafter. The effect of the adoption of the Standard in respect of the fair value model will be reported as an adjustment of the opening balance of retained earnings as of January 1, 2007.
The Company believes that the adoption of the Standard is not expected to have an effect on its financial position, results of operations and cash flows.

2. **Accounting Standard No. 29 - Adoption of International Financial Reporting Standards (IFRS):**
In July 2006, the Israel Accounting Standards Board published Accounting Standard No. 29, "Adoption of International Financial Reporting Standards (IFRS)" ("the Standard").
International Financial Reporting Standards comprise standards and interpretations adopted by the International Accounting Standards Board, and include:
a) International Financial Reporting Standards (IFRS)
b) International Accounting Standards (IAS)
c) Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and by its predecessor, the Standing Interpretations Committee (SIC).
Pursuant to the Standard, companies that are subject to the provisions of the Securities Law, 1968, and that are required to report according to the regulations published thereunder, will be required to prepare their financial statements in accordance with IFRS starting from the period commencing on January 1, 2008. These companies, as well as other companies, may adopt IFRS early and prepare their financial statements in accordance with IFRS starting with financial statements that are issued subsequent to July 31, 2006.

Note 2: Significant Accounting Policies (cont.)

aa. The effect of the new accounting standards during the period prior to their implementation (cont.)

2. **Accounting Standard No. 29 - Adoption of International Financial Reporting Standards (IFRS): (cont.)**
For transition purposes, companies that prepare their financial statements in accordance with IFRS will be required to adopt the provisions of IFRS 1, "First-time Adoption of IFRS".
A company that adopts IFRS commencing from January 1, 2008, and that has elected to include comparative data for only one year (2007) will be required to prepare an opening balance sheet as of January 1, 2007 ("Opening IFRS Balance Sheet"). The Opening IFRS Balance Sheet will require the following:
- Recognition of all assets and liabilities whose recognition is required by IFRS.
- De-recognition of assets and liabilities if IFRS do not permit such recognition.
- Classification of assets, liabilities and components of equity according to IFRS.
- Application of IFRS in the measurement of all recognized assets and liabilities.

In order to ease first-time adoption, a number of exemptions from IFRS have been granted in respect of the Opening IFRS Balance Sheet, which exemptions may be elected, in whole or in part. Exceptions have also been established which prohibit retrospective application of certain aspects of IFRS.
According to the Standard, the Company is required to include in a note to the annual financial statements as of December 31, 2007, a balance sheet as of December 31, 2007, and a statement of income for the year then ended, that have been prepared based on the recognition, measurement and presentation criteria of IFRS.
There are differences between IFRS and generally accepted accounting principles in Israel in the recognition and measurement of assets and liabilities and in reporting and disclosure requirements. These differences could have a material impact on the Company's financial position and results of operations.
The Company is evaluating the effect of the adoption of the new Standard on its financial statements but is presently unable to estimate such effect (as for the Company's preparations, see section ee.9 below).

3. **Accounting Standard No. 26 - Inventories:**
In August 2006, the Israel Accounting Standards Board published Accounting Standard No. 26, "Inventories" ("the Standard").
The Standard applies to all types of inventories, excluding work in progress arising from construction contracts, which is subject to the provisions of Accounting Standard No. 4, "Construction-type Contracts", inventory of buildings for sale, which is subject to the provisions of Accounting Standard No. 2, "Construction of Buildings for Sale" and financial instruments.
The Standard prescribes that inventories should be measured at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and costs necessary to make the sale. The cost of inventories should be determined based on the "first in - first out" (FIFO) method or using a weighted average cost, provided that the same method is applied in respect of inventories having a similar nature and use. Measurement of the cost of inventories based on the "last in - first out" (LIFO) method is not permitted.
In accordance with the Standard, when inventories are purchased under credit terms whereby the arrangement involves a financing element, the inventories should be presented at cost reflecting the cash purchase price and the financing element should be recognized as a financial expense over the period of the financing.
In respect of the allocation of conversion costs to inventories, the Standard prescribes that if in a particular period, generation is not at normal capacity, then the cost of inventories should not include allocation of fixed overhead costs in excess of that allocated based on normal capacity. Such unallocated overhead costs should be recognized as an expense in the statement of income in the period in which they are incurred. Furthermore, cost of inventories should not include abnormal amounts of materials, labor and other costs resulting from inefficiency.
When a write-down of inventories has been recognized and subsequently there is an increase in their value, the amount of the write-down is reversed. The amount of the write-down or its reversal should be recorded in cost of sales in the statement of income.

Note 2: Significant Accounting Policies (cont.)

aa. The effect of the new accounting standards during the period prior to their implementation (cont.)

3. **Accounting Standard No. 26 - Inventories: (cont.)**
The Standard will be applicable to financial statements for periods beginning January 1, 2007 and thereafter. The provisions of the Standard are to be applied retrospectively, by restating comparative amounts relating to prior periods.
The Company believes that the new Standard will not have an effect on its financial position, results of operations and cash flows.

4. **Accounting Standard No. 27 - Fixed Assets:**
In September 2006, the Israel Accounting Standards Board published Accounting Standard No. 27, "Fixed Assets" ("the Standard"). The Standard prescribes the accounting treatment of fixed assets, including the recognition of assets, determining their value in the books and the related depreciation and impairment losses to be recognized in their respect. The Standard also prescribes the required disclosure in the financial statements regarding the entity's fixed assets. Among others, the Standard's provisions include the following:
The initial recognition of fixed assets will be based on the cost of purchase. In addition to the purchase price, all the costs that can be attributed directly to bringing the asset to the condition and location required for it to be able to operate in the manner intended by management.
Furthermore, the cost includes the initial estimate of the costs of dismantling and removing the asset and restoring the site on which the asset is located, for which the Company incurred an obligation when the asset was purchased or as a result of its utilization for a certain period not for the manufacture of inventories during that period. The Standard determines that in respect of the purchase of fixed assets in consideration of a non-financial asset or financial assets or in consideration of the combination of financial and non-financial, the cost will be measured at fair value unless:
   a. The swap transaction has no commercial substance.
   b. The fair value of the asset received or the asset given up cannot be measured reliably. If the asset received is not measured at fair value, its cost will be measured according to the book value of the asset that had been given up.

After initial recognition, the Standard permits an entity to choose between the cost model or the revaluation model as its accounting policy and to apply it consistently to a class of fixed assets of a similar nature and use.
According to the cost model, the fixed asset will be presented at cost less accumulated depreciation and impairment losses.
According to the revaluation model, fixed assets are to be presented at a revalued amount, being the fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The revaluation of fixed assets is recorded directly to a capital reserve in shareholders' equity, net of income taxes. This capital reserve may be transferred directly to retained earnings once the asset has been disposed of or during the period of use of the asset (according to the rate of depreciation). Revalued assets will be depreciated based on the revalued amount.
According to the Standard, each component of a fixed asset with a different useful life and that has a cost that is significant in relation to the total cost of the fixed asset is to be depreciated separately. The asset is to be depreciated based on its useful life as determined by the Company, which will be reviewed at each year-end. Depreciation will be discontinued at the earlier of the date of the asset's classification as held for sale or the date of the asset's disposal. An asset held for sale is an asset which is available for immediate sale in its present condition, as to which the Company has a commitment to sell and in respect of which the sale is expected to be completed within a year from the date of classification. Furthermore, upon the adoption of the Standard, a change in the method of depreciation will be accounted for as a change in accounting estimate, that is prospectively, rather than by recording the cumulative effect of retrospective application, as was customary prior to the effective date.
The Standard is applicable to financial statements for periods commencing on January 1, 2007 or thereafter, except the following:

Note 2: Significant Accounting Policies (cont.)

aa. The effect of the new accounting standards during the period prior to their implementation (cont.)

4. **Accounting Standard No. 27 - Fixed Assets: (cont.)**
   a) A company that on the effective date chooses the revaluation model for a class of fixed assets - the difference between the revalued amount and the carrying amount on the effective date will be recorded in a capital reserve in shareholders' equity at that date. The company will not be required to restate comparative data.
   b) A company that has not included in the cost of fixed assets an initial estimate of the costs of dismantling and removing the asset and restoring the site on which the asset is located will be required to:
      1) Measure the liability at the effective date, in accordance with generally accepted accounting principles;
      2) Calculate the amount that would have been included in the cost of the relevant asset at the date on which the obligation was first incurred by discounting the aforementioned liability to the date of its initial incurrence using the company's best estimate of the historical discount rates adjusted for the risk relevant to that liability during the elapsed period;
      3) Calculate the accumulated depreciation in respect of the amount of the discounted liability up to the effective date based on the asset's useful life at that time;
      4) The difference between the amount recorded in respect of the asset, pursuant to 2) and 3) above, and the amount of the liability, pursuant to 1) above, should be recorded directly to retained earnings.

   In late January 2007, the Israeli Accounting Standards Board issued the proposed Accounting Standard No. 28, "Amendment of the Transitional Provisions of Accounting Standard No. 27, Fixed Assets" ("the proposed Standard"). In order to adopt Accounting Standard No. 27, the proposed Standard allows an entity preparing to adopt one or more of the exceptions stipulated in IFRS 1 regarding fixed assets in the financial statements for periods commencing on January 1, 2008, to adopt them on January 1, 2007. Pursuant to these exceptions, the entity is entitled to present fixed assets upon the date of transition at fair value as deemed cost. An entity that chooses to adopt fair value as the deemed cost will not restate comparative data but rather disclose this fact and the fair value as of January 1, 2007 in respect of each fixed asset thus treated. The Company plans to adopt the cost model as of January 1, 2007.

   The Company is evaluating the effect of the adoption of the new Standard on its financial statements but is presently unable to estimate such effect.

5. **Accounting Standard No. 23 - Accounting Treatment of Transactions between an Entity and its Controlling Shareholder:**

   In December 2006, the Israel Accounting Standards Board published Accounting Standard No. 23, "Accounting Treatment of Transactions between an Entity and its Controlling Shareholder" ("the Standard"). The Standard must be adopted by entities subject to the Securities Law, 1968.

   The Standard is applicable, among others, to transactions involving the transfer of assets, the assumption of liabilities, indemnification, waiver and the granting of loans.

   The Standard is not applicable to business combinations of companies under common control.

   The Standard determines that the evaluation of transactions between an entity and its controlling shareholder will be fair value. Transactions that have the characteristics of a shareholders' investment or a shareholders' distribution will be carried to shareholders' equity and will not be included in the controlled entity's operating results. The differences between the consideration determined in transactions between an entity and its controlling shareholder and the fair value of these transactions will be carried to shareholders' equity. Current and deferred taxes relating to items carried to shareholders' equity in respect of transactions with a controlling shareholder will also be carried directly to shareholders' equity.

   The Standard applies to transactions between an entity and its controlling shareholder carried out subsequent to January 1, 2007 and to loans granted to or received from the controlling shareholder before the effective date of the Standard.

   The Company believes that the effect of the new Standard on its financial position, results of operations and cash flows is not expected to be material.

Note 2: Significant Accounting Policies (cont.)

aa. The effect of the new accounting standards during the period prior to their implementation (cont.)

6. **Accounting Standard No. 30 - Intangible Assets:**
   In late March 2007, the Israel Accounting Standards Board published Accounting Standard No. 30, "Intangible Assets" ("the Standard") that prescribes the accounting treatment, recognition, measurement and the disclosure requirements regarding intangible assets that are not dealt with in another standard.
   An intangible asset is an identifiable non-monetary asset without physical substance. The definition of an intangible asset requires that such an asset be identifiable to distinguish it from goodwill. An asset is identifiable when it complies with one of the following criteria: it is separable - it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
   In a business combination, the acquirer recognizes the intangible assets of the acquiree separately from goodwill even if the assets had not been recognized by the acquiree prior to the business combination. Accordingly, the acquirer recognizes the acquiree's in-process research and development project as an asset separately from goodwill provided it meets the definition of an asset and it is identifiable (the separable criterion or the legal criterion).
   Goodwill that is internally generated is not recognized as an asset because it does not represent an identifiable resource controlled by the entity that can be measured reliably at cost.
   In order to assess whether an internally generated intangible asset meets the recognition criteria, the entity must distinguish the research stage from the development stage.
   No intangible asset arising from research is recognized. Expenses in respect of research are recognized in the income statement as incurred. An intangible asset arising from development is recognized if, and only if, the conditions stipulated in the Standard are met, including technical feasibility, the intent and ability to complete the intangible asset and use or sell it, probable future economic benefits deriving from the asset, the availability of technical, financial and other resources and the ability to reliably measure the expenditures attributable to the asset during its development.
   Measurement after initial recognition is by application of the cost model or the revaluation model. The revaluation model may be applied only when there is an active market. The Standard defines an active market as a market in which all the following conditions exist: the items traded in the market are homogenous; willing buyers and sellers can normally be found at any time; and the prices are available to the public.
   According to the Standard, an intangible asset's useful life must be assessed as either finite or indefinite. An intangible asset with a finite useful life is systematically amortized and the amortization period and method are reviewed at each year-end. In contrast, an intangible asset with an indefinite useful life is not systematically amortized but is subject to a test for impairment annually (or more frequently if there are changes in circumstances).
   The Standard is applicable to financial statements for periods commencing on January 1, 2007 or thereafter. The Standard is to be applied by retrospective restatement.
   The Company believes that the effect of the Standard on its financial position, results of operations and cash flows is not expected to be material, if any.

bb. Work in progress

The Company performs numerous jobs that are carried out during a short period of time (less than a year). The receipts for these jobs are calculated according to the planned scope of the job, and according to the labor rates that are determined by the Electricity Authority, and their objective is to cover the effective costs resulting to the Company for these jobs. In accordance with Accounting Standard No. 4, the Company defers the revenue recognition in respect to these jobs until it finishes performing the job. This deferral does not result in a distortion of the business results.

Note 2: Significant Accounting Policies (cont.)

cc. Investments in financed leasing

The investments in financed leasing are presented in the amount of the leasing fees receivable, in accordance with the amounts that are invested and the balance of the lease period.

dd. Costs in respect to environmental quality

Current costs for the operation and maintenance of the facilities for the prevention of the pollution of the environment and the expected provisions for costs, which refer to environmental restoration deriving from current or past operations, are carried to the Statement of Operations. Costs for preventing environmental pollution that increase the life or efficiency of the facility, or that decrease or prevent environmental pollution, are carried to the cost of fixed assets and are depreciated in accordance with depreciation policy practiced by the Company.

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority

As stated above, pursuant to the abovementioned Circular, the Company was required, among other things, to include a condensed note for the following issues, as prescribed by the Companies Authority.

1. According to the Government's decision of August 5, 2004, with respect to the general accounting standards regarding Government companies, this standardization is intended for the private sector. The unique standardization for Government companies is in addition to the standardization for the private sector, or as an expansion or honing of issues that are specific to Government companies, as detailed in the circulars of the Companies Authority. The unique standardization for Government companies will be executed in accordance with the law.

2. The Companies Authority determined targets for the Company (whether through legislation, Government resolution or an entity that is authorized to set targets as well as in agreements between the Company and the State or an authority on its behalf) whereby the Company will include in its financial statements material financial information that is relevant to the State and the other users of the financial statements in order to reach economic decisions.

- In respect to the compliance with supply failure minutes, see Note 3.e below.
- In respect to financial targets:

a) <u>Financial leverage</u>
The Electricity Authority determined a normative financial leverage ratio (for the financing of assets without assets under construction) between the shareholders' equity and the foreign capital of 1:2 (for the purpose of the rate, the Electricity Authority refers to the deferred taxes as being part of the shareholders' equity). The ratio that is reflected in the financial statements as of December 31, 2006 is similar to the ratio that was determined by the Electricity Authority - 1: 1.91. The payment of the dividend that was provided for and not yet distributed from the Company's earnings in the amount of NIS 2.2 billion, would change this ratio to one of 1:2.21.

b) <u>Meeting the target determined in the electricity rate regarding the ratio of the exposure between the foreign currency liabilities and the NIS liabilities</u>
The Electricity Authority determined that the composition of the foreign capital linked to the basket of currencies out of the total recognized foreign capital, will be reduced annually from 70% in 2002, down to 54% in 2006. The ratio that is reflected in the financial statements as of the balance sheet date is 34.54%.

Note 2: Significant Accounting Policies (cont.)

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority (cont.)

c) The rate for return on shareholders' equity
According to the rate policy, the Electricity Authority decided that the annual rate of return on the shareholders' equity will be 7% for the generation segment, 5.5% for the transmission segment and 6.2% for the high and low voltage distribution segments. As of the balance sheet date, the annual rate of return on shareholders' equity amounts to 10% for the generation segment, negative return of 2.1% for the transmission segment and negative return of 11.2% for the high and low voltage distribution segment, see Note 3.b below (this is in accordance with Company's split financial statements according to the generation, transmission and distribution segments, see Note 33 below).

3. A Government company will provide disclosure in its financial statements regarding the Companies Authority's policies as to the distribution of dividends out of the Company's profits (as for the disclosure in accordance with the requirements of this item, see Note 1.e above).

4. "A company is required to perform full reconciliation of the balances with the State, its authorities, other Government companies and interested parties. If written balance confirmations were not received from the authorized parties, as stated above, the company will provide disclosure regarding this in its financial statements".
The Company has filed applications for balance confirmations from 170 customers and 52 suppliers, of which it received confirmations from 9 customers and 8 suppliers, all corresponding to the balances in the Company's books. The Company also received one confirmation from a client and one confirmation from a supplier that were not compatible with the balances in its books. The Company is holding inquiries for matching the balances.

5. A company will provide disclosure regarding assets (attached and detached) in its financial statements as specified below:

a) The company will provide proper disclosure in the financial statements of its rights to material assets (attached and detached), which it holds or that are operated/held by it for the State or others , including assets that are or were in dispute with any of the Government authorities regarding their rights. This disclosure shall include the details of the Company's rights to those assets (freehold, leasehold and respective dates, in trust or other rights) as well as conditions, limitations or commitments that is has in connection with the above assets (the obligation to transfer the assets to the State, the obligation to receive approval for transferring the rights thereto etc.).
b) Details of the State's rights to the above assets.
c) Details of others' rights to the above assets.
d) The dates on which the rights discussed in a) through c) above were created.
e) The status of records or approvals granted or received in respect to these rights, such as registration or confirmation of ownership or lease or trust, protected lease, or license, orders for seizing/closing/other, recording caveats in the Land Registry Bureau or any other relevant bureaus and pursuant to any law.
f) Any existing disputes over the assets and rights attached thereto.
g) The company will provide disclosure in the financial statements of the implementation of the directives of the Companies Authority regarding control and reporting rules for attached and detached assets in Government companies in accordance with the Financial Statement Circular 2006-3 of September 17, 2006.
The information required above is not included in the financial statements due to employee sanctions (see Note 21.c below).
In a letter to the Director of the Companies Authority dated January 10, 2007, the Company's CEO states that back in 1998, the Company stated that it was preparing to collect the extensive amounts of material required. Furthermore, in 1998, a list of the Company's assets was transferred to the Ministry of Finance as of the date of the expiration of the concession and to date, the list of added assets is immaterial in relation to total assets and is irrelevant compared to the assets acquisition prescribed by the Electricity Sector Law.

Note 2: Significant Accounting Policies (cont.)

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority (cont.)

5. A company will provide disclosure regarding assets (attached and detached) in its financial statements as specified below: (cont.)

In addition, the Company does not possess the entire information as of today due to various problems in registering the many assets that have been accumulated over dozens of years and due to the considerable costs and duration required to issue assessments, to carry out current measurements and other planning information for the thousands of assets held by the Company, as required by the Companies Authority. The CEO also mentioned that in meetings held with the Companies Authority and representatives of the Company's management regarding the restructuring, the representatives of the workers committee announced that they would not allow giving out information to the State or transferring any documents in connection with the Company's assets and other.

h) The company will provide proper disclosure in the financial statements of the existence of real estate properties that are not economically used for the Company's operations and their use in relation to the potential use is partial and/or the consideration in their respect is partial and does not reflect adequate real proceeds.

To the best of the Company's knowledge, it will not suffer any material financial losses as above. Regarding certain assets (mostly administrative buildings), which are not populated, the Company has taken measures to realize them by way of sale or lease.

i) A company will provide disclosure in the financial statements regarding the actions involved in the location, identification and registration of the assets during the reported period and of the aforesaid actions that are to be taken and were not yet carried out.

At the Company's initiative, during the last few years, an intensive, focused and continuous procedure was begun to gather and coordinate all of the information of the Company's entire assets, which were scattered among departments and districts, including the transformation stations, mobile/temporary/leased facilities, etc., and to organize them as to everything related to establishing an assets book, registration of rights (including caveats, insofar as it is relevant), administration and oversight, including the evacuation of squatters from the Company's properties, or to arrange the status of those squatters in the Company's properties.

The Company has a complete principal assets book (which is updated from time to time), as well as book of inconsequential assets (about 12,244 assets, primarily transformation stations) which is currently being completed. In addition, the Company is acting to register its rights in its assets, both with regard to the principal assets and with regard to the inconsequential assets. During the reported year, the Company registered its rights with the Land Registry Office in respect to 58 sites, and in respect to 158 other sites, caveats were recorded.

j) A company will provide disclosure in the financial statements of significant assets for which it believes there is a material gap between their fair value and their carrying amount in the financial statements, which are not recorded in their full amounts in the Company's books, including based on appraisals or evaluations performed, or insurance appraisals, if performed.

The electricity rate basis includes full coverage (depreciation and return on capital) for all of the fixed assets presented in the Company's financial statements during the base period (see Note 3.a below). At this stage, the Company does not have any additional valuations, outside and independent, economic or for insurance purposes; however, the Company did perform a valuation of its assets as of December 31, 2005 pursuant to the principles of Accounting Standard No. 15 of the Israel Accounting Standards Board ("Standard 15"), and pursuant to which, the Company will not need to reduce the reduce the value of its assets (see Note 3.c below).

k) Significant appraisals or evaluations have been performed and will be delivered to the Board of Directors of the Companies Authority along with all other relevant details in order to insure their reasonableness, accuracy, reliability and independence in respect of the performers of the appraisals and evaluations, providing a reasonable time frame prior to the discussion of the draft of the financial statements in the Company's Board of Directors meeting. The Board of Directors will examine their reasonableness and ascertain that they do not include material misstatement as discussed in n. above.

Note 2: Significant Accounting Policies (cont.)

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority (cont.)

6. Appraisals or evaluations have been performed and they are material, as above, to the value of the details in the financial statements, these material appraisals or evaluations will be enclosed to the financial statements and disclosure will be provided, among others, to the matters described in the Companies Circular 2007-1 in an appendix. As for the disclosure required in this respect, see the actuary's opinion attached in the appendix to the financial statements.

7. Non-inclusion of misstatements in the financial statements and related information by the Government companies:

a) Government companies are required to ascertain that the financial statements and related information submitted by them do not include any misstatement, including information that might mislead a reasonable reader of the financial statements and related information.

b) The financial statements will clearly states that the presentations included in the financial statements and in the related information are solely the responsibility of the Company and are not binding to the State of Israel.

The Company asserts that to the best of its knowledge, no material misstatement in included in the financial statements and the disclosures in the financial statements, other than disclosures of standards, regulations, provisions, guidelines and such from the various government authorities, are under the sole responsibility of the Company's management and Board of Directors and are not binding to the State of Israel.

8. Transactions with the State of Israel, its authorities and other Government companies:

A Government company will provide proper disclosure in its financial statements regarding transactions and balances with the State of Israel, its authorities and other Government companies, including the accounting treatment of these transactions and balances. The company is to insure that the transactions are presented in correlation to their essence (transactions with the State as a sovereign, as an interested party etc.). If there is unclarity involving the matter, disclosure should be provided in the financial statements and actions should be taken in coordination with the Companies Authority and the other State entities to remove said unclarity. The Company believes that the proper disclosure has been provided.

The Company believes that such disclosure has been provided.

9. Disclosure of the transitional preparations to implement International Financial Reporting Standards (IFRS):

A Government company will provide condensed disclosure in its financial statements of the status of the preparation process according to the list of topics as follows in a-f below:

a. Mapping and identifying all the subjects and items in the financial statements that might be affected by the transition to IFRS.

b. Disclosing the existing treatment of IFRS in the current financial statements.

c. The treatment alternatives for IFRS pursuant to IFRS.

d. The alternative which the Company's management intends to suggest.

e. The effect of the proposed alternative and of other alternatives on the financial statements compared to the current status.

f. A condensed clarification of management's intention to opt for said alternative.

Note 2: Significant Accounting Policies (cont.)

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority (cont.)

9. Disclosure of the transitional preparations to implement International Financial Reporting Standards (IFRS): (cont.)

The Company's preparations for IFRS adoption:

- Adopting IFRS:
  In July 2006, the Israel Accounting Standards Board published Accounting Standard No. 29, "Adoption of International Financial Reporting Standards (IFRS)".
  1. The Company has defined the adoption of IFRS as a project of the utmost importance and has found that identifying the differences between IFRS and generally accepted accounting principles in Israel ("Israeli GAAP") requires considerable time and resources. Consequently, the preparations included appointing a senior chief of department to head the project, appointing a work team headed by the project manager to convene once a week to discuss and report the project's progress, setting up a steering committee headed by the director of accounting and economics to convene every two weeks and receive project updates, report to the CFO and CEO on an ongoing basis and report to the Board of Directors once a month.
  2. In principle, the IFRS adoption project was divided into three stages:
     a) Mapping and identifying the differences between the current accounting principles implemented by the Company compared to IFRS.
     b) Identifying the required changes in business processes and work methods, solution finding and analysis, analyzing the different treatment possibilities pursuant to IFRS and implementing the solutions, including the required changes in the information system, writing procedures etc.
     c) Implementing the changes, preparing an opening balance as of the date of transition (January 1, 2007) and re-preparing the financial statements for 2007 on a quarterly level.

- Mapping and identifying the differences between currently applied accounting principles and IFRS:
  At this stage, which was defined as the first stage of adopting IFRS, all the international accounting standards have been reviewed and the differences between those standards and currently applied standards have been analyzed. The team has concluded that there are five international accounting standards ("IAS") whose adoption might have a material effect on the Company as follows:
  1. IAS 16 - Property, Plant and Equipment.
  2. IAS 19 - Employee Benefits.
  3. IAS 23 - Borrowing Costs.
  4. IAS 39 - Financial Instruments: Recognition and Measurement.
  5. IFRS 1 - First-time Adoption of International Financial Reporting Standards and exceptions regarding the transition date.

  As of the date of signing these financial statements, stage A of IFRS adoption has been completed.

- The differences identified and the possible alternatives to the five international accounting standards described above:
  1. IAS 16 - Property, Plant and Equipment
     Historical cost is amortized according to IFRS. This calculation is based on the separation of assets into components (which is a much larger and broader separation than the current one) as in Accounting Standard No. 27, whose adoption is effective as of January 1, 2007, and determining a separate useful life and depreciation rate for each component. The Company retained an outside consultant for separating its fixed assets into material components and for determining their respective useful life and depreciation while making comparisons to what is customary in electric companies around the world. For implementing this alternative in the international standard, the Company is required to re-calculate the cost of every component (retrospectively) while referring to other international standards, including the recalculation of salary costs as recorded as part of fixed assets pursuant to IAS 19 as well as financial costs capitalized to fixed assets pursuant to IAS 23.

Note 2: Significant Accounting Policies (cont.)

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority (cont.)

9. Disclosure of the transitional preparations to implement International Financial Reporting Standards (IFRS): (cont.)

Furthermore, in accordance with the decision of the Israel Accounting Standards Board, January 1, 2004 was determined as the date for discontinuing the adjustment of financial statements to inflation according to IFRS. Until December 31, 2007, the Company will prepare its financial statements (see Note 3.b.9.c below) as adjusted to the changes in the Israeli Consumer Price Index by virtue of the Government Companies Law; however, under IFRS, the Company will be forced to discontinue the adjustment of its financial statements retrospectively from January 1, 2004. The Company cannot assess at this stage the net effects of cancelling the adjustment of fixed assets from that date through December 31, 2006, of the retrospective recalculation of salary costs and financial costs capitalized to fixed assets and of calculating the depreciation rates according to components.

Alternative for calculating the cost of fixed assets as of the date of transition:

Pursuant to IFRS 1, in lieu of the retrospective calculation, the Company may choose the alternative of evaluating its assets using their market value as of the date of transition, which the Company intends to perform through outside appraisers who are familiar with electricity markets worldwide. According to the provisions of international accounting standards, the Company may elect any of the above alternatives for each group of assets separately. The Company has decided to examine both alternatives simultaneously.

2. IAS 19 - Employee Benefits

   As of the date of transition, the Company may opt for one of the two alternatives:

   a) Recalculating salary costs retrospectively, namely, recalculating the liabilities for pension pay and the added salary components for the employees pursuant to IAS 19. Obtaining or retrieving these data retrospectively would be extremely complicated and present great difficulty.
   b) IFRS 1 allows first time adopters of IFRS to opt for an exception to IAS 19 and calculate the liabilities in respect of employees upon the transition date only.

   The Company has contacted actuaries for retrospectively calculating salary costs.

3. IAS 23 - Borrowing Costs

   Pursuant to this Standard, there is a limitation on the amount of borrowing costs with respect to exchange rate differences that can be capitalized to fixed assets under construction in respect of the Company's foreign currency liabilities. The Company is preparing to calculate and measure the exchange rate differences that can be capitalized using its information systems. Furthermore, after establishing the cost of fixed assets under construction according to IAS 16, the capitalization of borrowing costs will be done retroactively.

4. IAS 39 - Financial Instruments: Recognition and Measurement

   The purpose of this Standard is to set principles for recognizing, de-recognizing and measuring financial instruments. The main issue in the Standard that requires a change in the Company's accounting treatment in its books relates to financial derivatives. All financial derivatives (currently, mostly swap and forward transactions) will be measured and presented at fair value. Changes in their fair value will be carried to profit and loss as opposed to the current situation where swap transactions and the majority of forward transactions are presented at their contractual/liability value.

- Analysis and implementation of IFRS:

  The Company is preparing to adopt the required changes in business processes and work methods, solution finding and analysis, analyzing the different treatment possibilities pursuant to IFRS and implementing the solutions, including the required changes in the information system, writing procedures etc.

Note 2: Significant Accounting Policies (cont.)

ee. Condensed note pursuant to the financial statements circular 2007-1 published by the companies authority (cont.)

9. Disclosure of the transitional preparations to implement International Financial Reporting Standards (IFRS): (cont.)

- Other implications:
  Following the transition to IFRS, changes will be introduced into the Company's accounting treatment (the discontinuance of implementing SFAS 71 and the discontinuance of adjusting the financial statements), which might have material effects on the accounting exposure to changes in the Company's foreign currency exchange rates and consequently, the hedging policies against this exposure will have to be reexamined.

10. Disclosure regarding the preparations for reporting internal control over financial reporting. A Government company will provide condensed disclosure in its financial statements of its preparations for reporting on internal control pursuant to the list of topics prescribed in the Companies Authority Circular 2007-1.
The Company has prepared such a note as above in respect of the actuarial liability, whose findings have been adopted, and is in the process of preparing a similar report regarding fixed assets.

11. Pursuant to the Government Companies Regulations (Additional Report Regarding the Measures Taken and Presentations Granted to Secure the Accuracy of the Financial Statements and Directors' Report), 2005, these financial statements include letters of representation on P. 6-9.

Note 3: Decisions of the Electricity Authority

a. The current electricity rate

On July 5, 2002, the bases of the electricity rates and criteria for 2002-2005 and the manner for their updating came into force (hereinafter - "the rate document"). In that decision, it was determined that in the event that as of December 31, 2005, new electricity rate bases shall not be determined with regard to January 1, 2006 and thereafter, then the Electricity Authority's decisions will remain in force until the date on which new electricity rate bases are determined. As of the date on which the financial statements were signed, the Electricity Authority had not yet determined new electricity rate bases. The Electricity Authority's decisions with respect to structure and level of the rates are detailed in the rate document for the Company's activities segments - generation, transmission, the high-voltage distribution and the low-voltage distribution.

The rate document determines, among others, the following principles:

1. The recognized active assets base, which is adjusted pursuant to Opinion 36 of the Institute of Certified Public Accountants in Israel, serves in determining the coverage for the depreciation and financial expenses and the return on capital. This base was calculated for each of the four segments as follows:

a) The generation segment - The scope of the recognized active assets was determined based on analyses of the scope of the active assets in the Company's financial statements during 1995-1999 as the representative period (which, in the opinion of the Authority, constitutes the development cycle that ends with the full utilization of the economy of scale of the units that are fired by coal) in prices of December 31, 2000. In addition, during the rate period, the Electricity Authority will recognize the additional costs of the combined cycle gas turbines ("CCGT") that will become operable during the rate period, in excess of the cost of the open gas turbines that existed in the rate in 1995-1999, and the additional costs for modifying the existing units for the use of natural gas.

Note 3: Decisions of the Electricity Authority (cont.)

a. The current electricity rate (cont.)

The rate document determines, among others, the following principles: (cont.)

b) The transmission segment - The scope of the recognized active assets was determined, based primarily on the average active assets according to the financial statements for 2000, with certain adjustments.

c) The high-voltage and low-voltage and distribution segments - The scope of the recognized active assets was determined based primarily on a model that was developed by the Electricity Authority and that, pursuant thereto, the balance of the recognized active assets matches the averaged active assets according to the Company's financial statements for 2000. In addition, the Authority recognized additional costs in respect to the concealing of lines beginning in 2002, which is a consequence of the policy of the Ministry of National Infrastructures to conceal lines in urban areas.

2. In terms of the recognized costs of the rate bases to be realized:

i. Ratio between the shareholders equity and the foreign capital of one-third and two-thirds respectively for the purpose of electricity rate, the electricity authority refers the deferred taxes as part of the shareholders' equity;

ii. The composition of the foreign capital linked to the CPI or the Basket of Currencies of the Bank of Israel which changes every year;

iii. The variable interest rates on the foreign capital and the rates of return on shareholders' equity according to the segments.

a) The foreign capital component - As of July 5, 2002 (hereinafter - "the starting point"), the percentage of the foreign capital linked to the Basket of Currencies out of the total recognized foreign capital will be reduced progressively on an annual basis, from 70% in 2002 to 54% in 2006. The foreign capital balance which is not foreign capital linked to the Basket of Currencies, will be linked to the CPI. In addition, the Electricity Authority determined that the Company will need to hedge NIS 1,300 million in the framework of hedging insurance in excess of the above mentioned while the recognized cost for the purpose of the rate of this hedging insurance will be 1.15%.

The Electricity Authority has, as it did in the past, once again decided that the Company's accounting exposure in respect to part of its loans and debentures denominated in or linked to foreign currency, which finance fixed assets in use exclusively, will be passed on to the electricity consumers through the electricity rate. In its decision, it determined that the amount of the exposure will be determined according to the recognized percentage of foreign capital linked to the Basket of Currencies, as aforesaid, where it is linked to rate of the change in the exchange rate for the Basket and to the change in the annual amount of manufactured electricity.

The balance of the amount of the transferred exposure as of the balance sheet date amounts to approximately NIS 15.65 billion. Subsequent to the aforesaid decision, the Company generates a regulatory asset in respect to the financial expenses.

The decision determines that the differences between the changes in the exchange rate for the Basket of Currencies and the changes in the CPI in respect to the amount stated above will be passed on to the electricity consumers. These differences will be repaid to the Company or the consumers annually, at a rate of one fifth of the net balance of the differences (the declining balance method). Subsequent to this, and subsequent to the decision of Electricity Authority dated February 3, 1997 during the reported period, the Company recorded income by decreasing the provision in the amount of approximately NIS 34 million (presented in the other expenses (income) item).

b) The interest rates on the foreign capital - The starting point for the annual interest on foreign capital linked to the CPI was determined as 4.72% and the annual interest on the foreign capital, linked to the Basket of Currencies with the starting point determined as 6.99%.

These interest rates will change once annually, at the time of the annual rate update, taking into consideration the interest rates for the market (on a weighted basis) and, accordingly, the Electricity Authority determined that, beginning April 2, 2006, the recognized interest rates on the foreign capital linked to the CPI will be 4.86%, and the annual interest on the foreign capital linked to the Basket of Currencies for 2006 will be 6.75%.

Note 3: Decisions of the Electricity Authority (cont.)

a. The current electricity rate (cont.)

The rate document determines, among others, the following principles: (cont.)

c) The rate of return on shareholders' equity - The annual rate of return on the shareholders' equity, will be 7% on the generation segment, 5.5% on the transmission segment and 6.2% on the distribution segment at low and high voltage.

3. Fuels
The electricity rate includes a component to cover the Company's fuel expenses. This component was determined by an estimated mixture of the use of the various power stations (that consume various types of fuel and that, one from the other, have different efficiencies). The estimated fuel mixture is determined annually in advance based on various data, for example, the scopes of demand for electricity forecast for that year, and the expected availability for each of the power stations. The fuel prices are updated on a current basis.
In addition, the Electricity Authority determined that part of the fuel savings that will derive as a result from the switch to the use of natural gas will remain with the Company as an incentive.
In 2005, the rate of the incentive amounted to 20% of the aforesaid savings, and in 2006, the rate of the incentive amounts to 15%, while beginning in 2007 and thereafter, there will not be an incentive. The Company recently applied to the Electricity Authority requesting to continue leaving 15% of the savings in fuel costs in respect to the use of natural gas with it also in 2007 and afterwards.
The Electricity Authority has replied that what was determined in the past no longer applies. However, should the Company file a detailed proposal, including planned arrival dates for natural gas at each destination and their possible acceleration, and consequently hold a hearing regarding the incentive, the Electricity Authority will be willing to consider the request.

4. Amortization factors
Amortization factors for a sold kWh sold were determined which are supposed to result in efficiency for the Company and to reflect economies of scale at annual rates that are gradually accumulated. The annual rates are 2.1% (until April 2004 - 2.6%) on the inputs of the generation segment, net of fuel; 1.3% (until April 2004 - 1.5%) on the inputs of the transmission and transformer segment; - 2.5% (until April 2004 - 2.9%) on the inputs of the high-voltage distribution segment; 3.7% (until April 2004 - 4.1%) on the inputs of the low-voltage distribution segment.

5. The frequency for the current update for the rate bases
The electricity rates will be examined biweekly (with the publication of the CPI and with the publication of fuel prices), but the rates will effectively be updated in the event the inputs basket net of the amortization coefficients will change by at least 3.5%, or with the elapse of half a year from the last update, whichever is earlier. The differences that arise between the biweekly update (as stated above) and the effective update of the rate to the consumers will be included in the rate beginning with the date of the upcoming annual update in which the Electricity Authority updates the rate base. As a result of the foregoing, the Company generates a regulatory asset or liability in respect to the dates for the updating of the rates. In the reported period, the Company generated a liability that reduced the Company's revenues by an amount of approximately NIS 138 million, the balance of which at the balance sheet date amounts to NIS 163 million.
Each year, in April, the Electricity Authority will carry out an annual update of the various components of the recognized costs. The components to be updated are: interest on foreign capital, the fuel mix, the web and line concealment component, compensation for a delay in an update, costs for purchasing electricity from independent producers and different differences. (In 2006, the update was carried out in June, retroactive from April).

Note 3: Decisions of the Electricity Authority (cont.)

a. The current electricity rate (cont.)

The rate document determines, among others, the following principles: (cont.)

6. On September 9, 2005, in the framework of the coal prices, the Electricity Authority decided not to recognize costs that derive from the sanctions taken by the Company's employees. In light of this decision, the Electricity Authority offset about NIS 12 million from the Company's revenues for the period between April 2006 and February 2007 (in prices of April 2006). The Company recorded a provision regarding this matter in these financial statements.

7. Electricity Authority decisions reached during the reported period and the Company's position that disagrees with them:
During June 2006, the Electricity Authority reached several decisions that, for the most part, concern the annual update of the rate with which the Company disagrees.
Below is a brief description of the principal decisions and the Company's position regarding them:

a) Fuel mixture - After having decided to accept the Company's model as the derived methodology for determining the fuel mixture and for calculating the saving on fuel costs as a result of the usage of natural gas, the Electricity Authority set the parameters to be included in the calculation of the fuel mixture for 2006 as follows:
   1. The Equivalent Forced Outage Rates (EFOR) for 2006 will be based on the recommendation of the Advisor to the Electricity Authority and contrary to the Company's stance.
   2. The operation regime for F type CCGT at the Eshkol Power Station, as taken into consideration in the fuel basket for 2005, contrary to changes made by the Company in the operation regime for calculating the fuel basket.
      The Electricity Authority has accepted the Company's position and did not include real data of the demand curve in the first five months of 2006 in the calculation of the fuel basket in order to maintain the principle of recognizing normative costs.

b) Reading power station - The Electricity Authority decided that the 2006 fuel basket (that, in effect, was included in the rate for the year commencing in April) will be updated taking into consideration the fact that the Reading power station in Tel-Aviv was operated with fuel oil during the first of 2006, and that only beginning in the second half of the year will it be operated with natural gas. In spite of this, and despite the fact that during the entire year of 2005 and the first half of 2006 the power station was operated with fuel oil, the Electricity Authority did not agree to retrospectively correct the 2005 fuel basket, a basket that was determined assuming that the Reading power station began operating with natural gas during the second half of 2005. In the Company's assessment, not correcting the fuel mixture for 2005 resulted in an impairment of the Company's profitability by an amount of about NIS 200 million (about NIS 150 million net of the tax effect).
   In addition, during the period between March and June 2006, the Reading power station was closed by order of the authorized authority - the Ministry of Environmental Protection. From that date, in order to provide a solution to the demand for electricity, the Company was forced to produce electricity with more expensive fuels. The Electricity Authority did not consent to the Company's request to recognize this cost. What emerged from the Company's preliminary examination was that as a result of this decision the Company's profitability was impaired by an amount of about NIS 170 million (about NIS 125 million net of the tax effect).

c) Electricity consumption for the Company's facilities - The Electricity Authority did not recognize the electricity consumed at the Company's facilities that are used in order for the Company to function. In the Company's assessment, this determination by the Electricity Authority is wrong, since the aforesaid consumption constitutes a generation input as in any other plant. What emerged from the Company's preliminary examination is that the Company's profitability will be impaired annually by an amount of about NIS 30 million (about NIS 23 million net of the tax effect).

Note 3: Decisions of the Electricity Authority (cont.)

a. The current electricity rate (cont.)

The rate document determines, among others, the following principles: (cont.)

d) Recognition of financing costs - The Electricity Authority rejected the Company's request to recognize interest costs in their actual amounts; in other words, the rate of return on State debentures and a margin of 1.23%, and left the margin at 0.73%. The Company disagrees with this decision of the Electricity Authority that conflicts with reality. The effect of this decision will gradually increase with each new capital raising effected by the Company.

e) Purchase of natural gas in spot transactions - The Company applied to the Electricity Authority requesting the determination of a rate policy for the recognition of the costs for a transaction involving a spot purchase of gas (in addition to the gas the Company buys pursuant to a long-term agreement). The Electricity Authority agreed to recognize the aforesaid transaction, however, it determined a cap price to be recognized for the Company, a price that is materially lower than the effective price for gas bought in spot transactions. During the reported period, the Company recorded a provision in an amount of about NIS 74 million (about NIS 55 million net of the tax effect).
Should this matter not be resolved, the Company intends to examine if it will continue to purchase natural gas in spot transactions during 2007. During the reported period, the Company entered into an agreement to buy natural gas in a spot transaction with the company Tetis Sea, and began buying the gas (see Note 21.a.3 below).

f) Average loss from the collection of the rate - The Electricity Authority determined annual revenues that the Company is allowed to collect, subsequent to which various electricity rates are determined for the various groups of consumers that are designated for the purpose of collecting these revenues. The various rates were determined according to a forecast of electricity consumption for each of the consumer groups as they were in 2000. In the Company's assessment, subsequent to the transition of consumers to load and time rates ("LTR"), and supply margins at high-voltage and very high-voltage that derive from the change in consumer habits during the last few years, as well as the flexibility granted to electricity consumers, primarily the major ones, to change the hours of their consumption. The Company does not collect the revenues that are due to it, and bears major losses each year.
According to the Company's calculations, it suffered losses subsequent to the above in an amount of about NIS 231 million in 2006 (about NIS 173 million net of the tax effect). The Company applied to the Electricity Authority to correct the rates structure, such that it will be able to collect the full amount of revenues due to it. The Electricity Authority's response has not yet been received.
Regarding the implications of the Company's disagreements with the Electricity Authority concerning these decisions, see section c below.

b. The future electricity rate

1. The model for the recognition of costs in establishing the distribution network

As stated above in section a1, the recognized costs for the distribution segments in 2000 were determined based on a model that was developed by the Electricity Authority for the reassessment of the distribution assets. The Company disputes the principles of this model, and in June 2002 it submitted its approach in respect to it. The director of the Electricity Authority clarified to the Company that the Electricity Authority will study the model to be recommended by the Company, and that until a decision is reached regarding this matter, the scope of the Company's investments in the distribution segment will be studied (that will be recognized in the framework of the determination of the next rate) based on the principle elements of the rate; that is, in accordance with the growth in the sales of electricity (kWh).
On February 29, 2004, the Company submitted the aforesaid model. In November 2005, the Authority appointed a consultant who will examine the models for the development of the distribution system that were suggested by the Company.

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

1. **The model for the recognition of costs in establishing the distribution network (cont.)**
   The letter received by the professional team at the Electricity Authority in October 2006 stated that in principle, it is adopting the models formulated by the consultant for examining the development in the high and low voltage distribution network and it intends to recommend before the Electricity Authority's plenum to adopt said models in order to determine the level of recognition of the costs of the development in the distribution networks based on the new rates. The formed model for examining the development in the high voltage distribution networks differs from the model suggested by the Company whereas the model suggested for examining the development in the low voltage distribution networks is identical to the model suggested by the Company.
   The Company has reservations regarding the suggested models and has requested to hold a joint hearing attended by the professional teams of both the Electricity Authority and the Company, before the models are adopted by the Electricity Authority.
   According to accounting principles for regulated companies, a regulated company must amortize the amount invested in fixed assets that most probably will no be recognized for it for rate purposes. At this stage, the Company cannot assess the scope of assets not recognized under the next base rate, if at all, and has not recorded any provision in its respect.

2. **Depreciation for fuel oil power stations:**
   Following the change in the estimated economic life of the fuel oil power stations effected by the Company in 2001, on March 14, 2004, the Company decided that the accumulated difference in the amortized costs for the fuel oil power stations, during the period between July 2002 and the date for the next update in the rate basis, will not be recognized in the framework of the recognized costs in the electricity rates that the Electricity Authority will determine at that time. The balance of the regulatory liability that the Company recorded in respect to the aforesaid amounts to NIS 231 million as of December 31, 2006.

3. **Liability for pension:**
   On March 25, 2004, the Company applied to the Electricity Authority requesting that it recognize the amount of about NIS 1,146 million as a recognized expense that will be covered in the electricity rate, spread over no more than 10 years. This amount constitutes an increase in the actuary liability that was included in the Company's financial statements in 2003, and which originates from the adoption of the principles for calculating the actuarial liability that are prescribed by the supervisor of the capital markets and savings division at the Treasury, and other decisions the effect of which is exogenous on the amount of the actuarial liability.
   In reply to this request, the Electricity Authority notified the Company that, in view of the complexity and importance of the issue, it appointed a team of outside consultants in the accounting and actuary sectors ("the consultants team"), in order to coordinate the required findings and calculations, including a rate approach to the implications of the setting up of a central pension fund. The issue in its entirety will be presented for discussion and a decision on Electricity Authority plenum.
   During 2004 and 2005, the Company received a draft report from the consultants team for review and comments. What emerges, among others, from an examination of the draft committee report, is that the consultants team accepts the change in the actuarial assumptions performed by the Company in 2003, however in its opinion it is necessary to change additional actuarial assumptions regarding the increase in salaries and pension, such that the difference will offset each other, an no additional recognized expense will be added to the electricity rate. The actuarial assumptions the consultants team recommended changing are both in respect to the forecasted real increase in pension pay for pensioners from an average of 2% per year to an average of 0% per year.
   The Company studied these recommendations, and based on the opinion of its outside actuary, it decided that it is unnecessary to change the assumptions regarding pensioners, which is based on an examination of effective data regarding the past, based on the evaluation of the head actuary at the Ministry of Finance and of an external actuary and also of the actuary of the Company (according to which, an assumption of a real

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

3. **Liability for pension: (cont.)**
increase in pension at a rate of 2% per year, where the pension is updated according to the rate of the increase of the employee's rank at the time of his retirement is, at first sight, reasonable), and based on the Company's labor agreements, the existing assumption of a real increase in pension at an average rate of 2% per year is very reasonable.
In the evaluation of the Company's outside actuary, the determination of real increase in pension at a lower rate will result in an undervaluation of the liability, and will not reflect the scope of the Company's actuarial liability.
On February 26, 2006, the Company presented its comments on the consultants team's draft report to the director of the Electricity Authority. For various reasons, both legal and actuarial, in its comments, the Company disputes the principal conclusions of the consultants team, including the mater of forecasted real growth for pension pay to the pensioners.
During 2005 and in early 2006, the Company applied to the Electricity Authority, the objective of which was to obtain recognition in the rate for the not yet amortized actuarial losses and which were recorded pursuant to International Accounting Standard No. 19 ("IAS 19"). As of the balance sheet date, the balance for the not yet amortized actuarial losses amounts to about NIS 4 billion, and in the Company's opinion, this amount is supposed to be covered by the rate according to rate by which it is amortized in the financial statements. That is, over a period of 15 years. As of the date on which these financial statements were signed, the matter is under discussion and a final decision regarding it has not yet been reached.

4. **On February 20, 2005, the Electricity Authority reached the following decision:**
"The Authority requests to express its concern regarding the scope of investments planned by the Company, and that will be financed in the framework of the capital raisings the Company intends to carry out in the very near future. The cost of these planned investments on behalf of the Company is not covered in the current rate outline that the Authority approved. Therefore, these expenditures are liable to be made without a future rate coverage, which is in spite of the fact that the current rate structure implies coverage for future costs deriving from an increase in electricity demand (including a reserve in generation and a special addition for the new combined cycles). The Authority, as a professional body with special authority and expertise in aspects of costs in the electricity sector, feels obliged to express this position before an irreversible situation arises through the publication of a prospectus and actual capital raisings by the Company."
The Company is acting according to development plans that were and will be approved by the responsible Minister. The Company believes that all of the investments detailed in the Company's investments plan are for the purpose of the development of the electricity sector and, therefore, are appropriate and essential. Nonetheless, with respect to part of the plans that were not yet approved by the Minister, discussions will be held with the Ministry of National Infrastructures as to how to realize them.

5. On March 15, 2005, the Electricity Authority reached a decision that calls on the Company to relate to the recommendations of the Electricity Authority's professional team concerning the controls of costs in the generation segment, for 2004.
The professional team displayed a rate approach that is derived from an accounting policy that is different from the Company's policy concerning the additional investments in the generation systems that are operated, and in the establishment costs for power stations of the combined cycle generation type.
    a. In the opinion of the professional staff, only investments that resulted in additional output, an increase in efficiency and an extension of the life of the generation units constitutes an investment in operating generation units.
    The professional staff studied the additions to the Company's assets for 2004, from which it emerges in its opinion, that an amount of about NIS 134 million (out of the about NIS 700 million that was studied) that was invested in existing power stations does not meet the above criteria. The Company disputes the professional team's findings regarding the criteria that were cited by the Electricity Authority, as stated above. Further, the Company pointed out that its accounting policy is consistent over the years and, accordingly, an investment is defined for it as any expense that results in a future economic benefit.

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

b. The professional team argued that in contrast with the normative data that were furnished in the past by the Company, as they emerged from the costs audit, the actual costs data for power stations of the combined cycle generation type are higher by approximately 12%. In addition, the length of time for building the Company's generation units is relatively protracted, which results in the capitalization of interest costs for a relatively lengthy period.

In its response dated March 23, 2005, the Company disputes this position of the Electricity Authority, and gave detailed reasons for the gaps between the normative prices to the actual costs, where the principal factor is the devaluation of the exchange rate for the dollar in relation to the Euro. The Company is unable to assess which costs the professional staff is referring to.

In addition, the Company requested to deliberate the professional issues with the Electricity Authority.

On March 29, 2005, the chairman of the Electricity Authority addressed the Company's response and explained the professional team's decision. In his remarks, he notified the Company that the discussion it requested will be held and, for that purpose, he requested that the Company would furnish additional data regarding the investments in the generation system.

Regarding the matter of the costs for establishing combined cycle generation units, the Electricity Authority in its letter from March 2006 further to the decision from December 2005) however recommended principles for the methodology for recognizing the costs in establishing combined cycle generation units. Pursuant to the principles of the Electricity Authority, the average cost per kilowatt that will be recognized for the Company will be lower than the average cost forecasted by the Company.

During October and November 2005, the Company received several letters from the supervisor of the Electricity Authority's accounting and methodology division regarding the construction of a combined cycle generation unit, and including a proposed decision of the Electricity Authority that is based on these letters. It was clarified in these letters that, in accordance with the position of the supervisor of the accounting and methodology division, there are exceptional costs that arose at the time the combined cycle unit was constructed that will not comply with the conditions of costs controls. Therefore, he intends to recommend to the Electricity Authority to recognize the costs for this power station (as well as for other stations of this type) at an amount that will not exceed the amount budgeted by the Company for this station, where this amount includes the charge of the capitalization of interest and general expenses for this amount, for the recommended period for constructing the project. Nevertheless, specific additional costs that are required in the Company's opinion regarding a specific station will be approved by the Electricity Authority on an individual basis. After studying the issue, the Company does not agree with the content of the above letters. In the Company's opinion, the construction period involves the granting of statutory approvals that are not under the Company's control and this is the reason why the statutory procedure lasts much longer than what is customary.

In March 2006, the Company received an additional letter from the supervisor of the Electricity Authority's accounting and methodology division regarding the same matter, in which there are details regarding the foremost principles for recognizing costs, as follows:

a) Planned basic cost - the basic cost on which he relied is the cost that was planned for the project according to the Company's data, which is adjusted for the dates on which the decisions for constructing the stations were reached.

b) Euro-dollar differences - the Electricity Authority recognizes for the Company in the normative capital structure and in the hedging of the Company's currency exposure to foreign capital. Beyond this recognition by the Authority, the Company needs to hedge itself and its risks the rest of the currency exposures.

c) Capitalization of interest during the construction - the customary construction period, from the aspect of the rate, for constructing a cogeneration unit is approximately two and a half years.

d) Exceptional expenses - for the purpose of recognizing these costs in the rate, the head of the accounting and methodology division recommends to the Electricity Authority will specifically recognize exceptions of up to 6% of the Company's total planned costs with regard to the stations under construction. In cases of exceptions arising from "force majeure", there could be a possibility for recognition during a construction period longer than two and a half years, and all which that implies, from the aspect of the recognition of the capitalization of financing costs.

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

In May 2006, the Electricity Authority had a hearing regarding this matter in which the Company presented its position. As of the date on which these financial statements were signed, the Electricity Authority had not yet reached a decision on this matter.
In the Company's assessment, as emerges from the above letters, the cost for constructing the above generation units is expected to exceed the recognized costs appearing in the letters described above by about $245 million. Pursuant to accounting principles for regulated companies, a regulated company must amortize the amount invested in fixed assets that most probably will not be recognized for it for purposes of the rate.
The Company disputes the recommendations of the supervisor of the Electricity Authority's accounting and methodology division, and in its opinion it has good arguments and that they will be accepted by the Electricity Authority.

6. On August 11, 2005, the Company received a document from the Electricity Authority's professional team ("the professional team") titled "Recommendation for Discussion Regarding the Accounting and Financial Principles for the Basis of the Nest Electricity Rate". The document includes recommendations for changing the manner by which the Electricity Authority will recognize the Company's investments in fixed assets in the future. The professional team's position is that part of the construction costs that include salary, financing, depreciation, maintenance and general costs will be carried to the income statement instead of being carried to the cost of assets, as was practiced until now, where 80% of these costs will be recognized in the electricity rate base in the framework of the coverage of the Company's operating costs. The ramification of this position, pursuant to the professional team's estimate, is an increase in the Company's expenses by an amount of about NIS 350 million in the initial year, and up to about NIS 900 million from the third year and thereafter, to the basis of this recommended electricity rate, which will be covered accordingly in the amount of 80% annually through the operation component in the rate. The remaining balance of 20%, for which there is no electricity rate coverage, will serve as the efficiency factor in the construction of fixed assets. Following the receipt of the above recommendations of the professional team, the matter was discussed with the Electricity Authority, and there was also an exchange of correspondence concerning the issue between the Electricity Authority and the Company. The Company rejects the professional team's recommendations, which is, among others, based on the comments and calculations that it conveyed to the Electricity Authority with respect to the above recommendations. As of the date on which these financial statements were signed, a decision has not yet been reached by the Electricity Authority regarding the above recommendations.

7. On December 18, 2005, the Electricity Authority reached a decision regarding the principles for determining the bases for the new electricity rates and the costs for cogeneration units, as follows:

a) The Electricity Authority hereby determines the foundations for the work plan for determining the bases for the new rates.

b) The foundations:
   1) Determination of rate bases on the basis of normative costs for the long-term.
   2) Definition and clear distinction between the various operating segments in the electricity chain and the definition of the reciprocation between them.

c) The stages and principles for handling the work plan -
   1) Individual definition of the various activities segments in the electricity chain and a reallocation of the recognized costs to these segments based on the costs that the Electricity Authority determined in its decision of July 2002. In this context, it should be clarified that the manner for allocating the costs will be based on the principle of "ownership versus use", in a manner that the recognized rates for each segment will indeed reflect the segment's physical assets, the services provided by the segment to its consumers in and out of the Company and the payments to another segment.
   In the decision dated July 10, 2006, the Electricity Authority defined the various activities segments in the electricity chain and reallocated the recognized costs to these segments on the basis of costs that were determined by the Authority in the rate basis of July 2002. These costs were attributed pursuant to the "use versus ownership" principle.

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

7. On December 18, 2005, the Electricity Authority reached a decision regarding the principles for determining the bases for the new electricity rates and the costs for cogeneration units, as follows: (cont.)

2) Determination of a new rate basis for the generation segment (including consumer costs - standard payment):
The Electricity Authority intends to update the format of the recognized costs for the distribution segment. The format will set limits for the level of investments allowed per year in order to maintain the level of services to the consumer, including the reliability of supply and connections to the web. To accomplish this, the Electricity Authority appointed a consultant who will examine the models for the development of the distribution system that were suggested by the Company. At this stage, he is studying the quantitative aspects.

3) Determination of a new rate basis for the transmission segment:
The Electricity Authority views the accurate and updated definition of the activities of the transmission segment prior to determining its costs as being of great importance. This is due to its being a unique segment that provides essential services between the Company and private parties that operate in the electricity sector. In light of this, the Electricity Authority feels that it is necessary that the Company will act immediately to organize itself administratively in order to enable the activities in this segment as a distinct and consolidated segment in the framework of the license as a an essential service supplier. The costs involved in the aforesaid preparations will be included in the framework of the recognized costs for the segment, which is subject to carrying the organization process. Among others, the transmission segment will include the following activities: Forecast of demand and consumption in the market, master planning, simulations of system stability on the part of the generation and consumption jointly, integration and oversight activities, master control over the entire transfer of electricity in the system, including the manner for managing the trade.

d) The principles for determining the level of the recognized costs:

1) Defining the level of the capitalizations that will be recognized in the capital costs.
2) Reexamination of the mechanism for rate hedging for the Company's foreign currency liabilities.
3) Implementation of the Authority's decision regarding Accounting Standard 12 (see section 9) below).

In this decision, the Electricity Authority indicated that, to begin with, it intends to determine a new rate for the generation system, and afterward for the distribution system, and only at the end for the transmission system. The Company believes that the sequence for determined the aforesaid rates, in which the Electricity Authority determines the rate in the initial stage precisely for the most profitable system and only in the last stage with the most losses is incorrect, and that it is necessary to start with the transmission rate.

8. Currency exposure

On January 26, 2006, the Company received a request from the Electricity Authority in order to receive its remarks regarding the neutralization of the currency exposure in the electricity rate (see section 3.a2 above).
In this request, the Electricity Authority presented several alternatives for dealing with this issue. In the Company's assessment, changing the current mechanism is liable to result in changes in the Company's exposure in respect to its financial liabilities.

9. Accounting Standard No. 12

a) As stated in Note 2.aa above, in accordance with Accounting Standard No. 29, as of 2008, the Company will adopt IFRS. At this stage, the Company cannot evaluate the effect of the adoption of IFRS on its profitability measurement and balance sheet balances. The Company is of the opinion that the Electricity Authority should adjust the electricity rates so that they cover the costs as reflected by the new accounting principles and has addressed the Electricity Authority in order to discuss any relevant change in accounting principle with the Authority. In a letter of February 21, 2007, the director of accounting and methodology at the Electricity Authority announced that in view of the complexity of the accounting changes involving the assimilation of IFRS, he intends to participate as an observer in the follow-up meetings to be held in the Company for examining the adoption of IFRS.

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

9. Accounting Standard No. 12 (cont.)

Financial reporting according to IFRS requires the Company to recognize in the financial statements index and exchange rate linkage difference (in relation to nominal NIS and not adjusted NIS as currently applied) in respect of net financial liabilities not in nominal NIS.

As stated above, if the electricity rates are not thus adjusted to cover the costs reflected by IFRS (see also Note 2.ee.9), the result may be a material adverse effect on the Company's profitability and financial position.

In 2004, before it was decided to enact IFRS in Israel, the Company filed a request with the Electricity Authority to become aware of the Authority's policy, if and when the Company would be required to adopt Accounting Standard No. 12 of the Israel Accounting Standards Board (the discontinuance of the adjustment of financial statements). The Electricity Authority's decision with respect to the Company's request was as follows:

1) The capital costs recognized in the electricity rates to cover the costs of the assets operated until December 31, 2003, will continue to be determined based on the annual return and depreciation linked to the Consumer Price Index, with the addition of real return.
2) The capital costs recognized in the electricity rates that will be operated from January 1, 2004, will be determined based on the unlinked annual return (depreciation) with the addition of the nominal return. The amount of the recognized capital costs will be determined later on. The method for determining the capital costs in the electricity rate will not change until the annual update in respect to 2004 that will be carried out in 2005.
3) In accordance with the explanations to the decision, it was clarified that the capital costs for the coverage of the assets that will be operated as of January 1, 2004, will be attributed to the increase in output in excess of the level of output in 2003.

   Should the decision of the Electricity Authority regarding the above request remain in effect and will be expressed by determining a rate that will apply with the transition to IFRS and in the event that an amendment to the above is not rendered in the context of anticipated amendments in the electricity sector, the above might have a significant negative effect on the Company's financial position (as reflected in the financial statements), a damage to its economic rating and its ability to repay its liabilities, with all the grave sectorial and national ramifications involved.

b) The Minister of Finance, pursuant to his authority, enacted regulations pursuant to section 33 a to the Government Companies Law, and pursuant thereto the Company will continue to prepare its financial statements on the conventional basis of historical costs adjusted for the changes in the general purchasing power of the shekel, which is as of January 1, 2004 through December 31, 2007 (see Note 2.a.3 above).

10. Decisions of the Electricity Authority reached during the reported period

Recognition of the costs for the natural gas transmission agreement - On October 19, 2006, the Electricity Authority reached a decision that replaces its previous decision on the matter dated July 10, 2006, to recognize the costs for the transmission agreement between the Company and Natural Gas Lines Ltd. ("Natural Gas Lines") (see Notes 13 and 21 below). It further determined the manner for recognizing the costs on an annual basis of the scope of the order of capacity, which will be made in accordance with the development of the transmission system and in accordance with the mechanism for recognizing costs in the Authority's fuel basket.

11. On March 19, 2007, the Israeli Knesset passed a second and third reading of a bill for an amendment to the Electricity Sector Law (Amendment No. 6) (Reduced Rates), 2007. The bill has not yet been officially published. According to the bill, a consumer who has reached legal retirement age and is entitled to income support from the State, will pay a reduced rate of 50% of the home consumption rate for the first 400 kWh consumed on a monthly basis for home consumption only. It was further determined that the Minister, in consultation with the Minister of Welfare and under the Minister of Finance's consent, may prescribe in the regulations rules regarding the entitlement to reduced electricity consumption rates according to quantities determined by quotas.

Note 3: Decisions of the Electricity Authority (cont.)

b. The future electricity rate (cont.)

These quotas will apply to home consumers based on their domestic status and economic and medical conditions. The Minister, in consultation with the Minister of Welfare, will also determine the criteria for establishing such entitlement as above and the manner of submitting the information to prove entitlement within 60 days from the publication of the law.

The bill further states that in determining the electricity rates for the general public of consumers, the Electricity Authority must take into consideration the reduction of electricity rates paid by those eligible for discounts according to said regulations so that the licensed electricity supplier's revenues are not subtracted as a result of the reduction and the entitlement to reduced rates is established such that the total deduction of electricity fees by law will not exceed an amount equal to 1.5% of total fees paid by the public of consumers for electricity consumption. The law will be applicable within three months from its publication.

c. Disputes between the company and the electricity authority

1) Further to the disputes regarding the Electricity Authority's previous decisions, the Company disputes the Electricity Authority's decisions described above in section a.7) regarding the update of the current rate on the positions of the Electricity Authority and the professional team at the Authority regarding the upcoming rate, as described above in section b., and the Company also expressed its opinion to the Electricity Authority on the need to cease the amortization in respect to increasing efficiency, the need to continue receiving a gas incentive in future years and for the coverage of the exogenous expenses.

The Company is of the opinion that the reference is to unreasonable and tendentious decisions, and that the Company did not receive the explanations it requested regarding these decisions.

In addition, and according to what was stated above, the Company is unable to estimate the implication of the Electricity Authority's decision regarding the upcoming rate on its financial position; however, if a corresponding amendment is not rendered in the context of the anticipated changes in the electricity sector, the Company is of the opinion that in not raising the electricity rates at the time the upcoming rate basis is determined together with the Electricity Authority's decision regarding the current rate that is described above in section a.7), will lead to a material impairment of the Company's profitability to the extent of losses.

In August 2006, the Company applied to the Electricity Authority requesting that the Electricity Authority would hold another discussion on the above decisions, and a request to obtain data that the Authority used in order to reach those decisions, which is in order to fundamentally study the decisions.

Since the Company is still unable to assess the results of the aforesaid additional discussion, as well as what the Electricity Authority's decision would be regarding the rate basis that will be in force following the end of the current rate period (including the decisions described above in section b), the Company did not record any provision in respect to the matter under discussion. Furthermore, the Company is unable to estimate the implications of the above on the financial statements and its financial position.

In light of the serious implications that are liable to derive from the aforesaid, in August 2006, the Company applied to the ministers requesting that an urgent discussion be held regarding the Company's matters. In the Company's opinion, the continued reaching of unreasonable decisions by the Electricity Authority that are not pursuant to the law and without any explanations or without furnishing data, all of which is without a concrete possibility of appealing its decisions, and in the event that an amendment is not rendered in the context of anticipated changes in the electricity sector, is liable to impair the commercial results in a manner that will make it extremely difficult to raise cash, and will impair the possibility of servicing the Company's debt that, as of the balance sheet date, amounts to about NIS 45 billion. The Board of Directors also applied to the CEO and instructed him to prepare a cost savings plan for the Company.

Note 3: Decisions of the Electricity Authority (cont.)

c. Disputes between the company and the electricity authority (cont.)

2) Application of SFAS 71

The Company applies the accounting principles for companies whose rates are regulated (SFAS 71) that enable, under certain conditions, accounting treatment that is different from what is generally accepted with respect to the timing for the carrying of expenses and income to the statement of income (see Note 2.b to the annual financial statements). One of the conditions for applying this SFAS 71 prescribes that the regulated rates are constructed such that they will cover the specific costs (including return required for capital), with respect to the supplying of a regulated service or product.

In the Company's opinion, the Electricity Authority's decisions and the position of the Electricity Authority's professional team which the Company disputes (see section 1 above) are liable to raise doubts about the Company continuing to comply with the conditions for applying the Standard. In the Company's assessment, the application to the ministers concerning its positions and decisions, the Company's application toe the Electricity Authority to hold another discussion regarding those decisions and positions, and the cost saving measures the Company intends to carry out, will result in the Company's continued compliance with the aforesaid conditions (it will achieve profitability at the level of the required return on capital), although there is no certainty of this.

In the Company's opinion, the Electricity Authority's decisions and the position of the Electricity Authority's professional team which the Company disputes (see section 1 above) are liable to raise doubts about the Company continuing to comply with the conditions for applying the Standard. In the Company's assessment, the application to the ministers concerning its positions and decisions, the Company's application toe the Electricity Authority to hold another discussion regarding those decisions and positions, and the cost saving measures the Company intends to carry out, will result in the Company's continued compliance with the aforesaid conditions (it will achieve profitability at the level of the required return on capital), although there is no certainty of this.

Nonetheless, should the Company no longer comply with SFAS 71, it will need to write off the regulatory assets (and not to generate new regulatory assets in the future), and to study a provision for impairment of value of other assets, in accordance with the principles set forth in Standard 15.

d. Details of the amounts of the regulatory assets (liabilities), net as of the balance sheet date

	December 31, 2006	December 31, 2005
	NIS in millions	
With respect to the erosion of the Company's liabilities in foreign currency passed on to the electricity consumers (see section a.2a above)	(320)	381
With respect to the frequency for updating the electricity rates (see section a.5 above)	(163)	(25)
With respect to depreciation for fuel oil power stations	(231)	(219)
Consumer package (1)	34	351
Total	**(680)**	**488**

(1) The regulatory assets recorded in the past are linked to the CPI and are collected in equal amounts over a period ending in February 2007.

The regulatory assets balance is after the reduction of the effect of the amortization factors that will apply, as applicable, at the time the asset is collected (see section a.4 above).

In the Company's assessment, even should the changes in the electricity sector be carried out as stated in the Electricity Sector Law (see Note 1a1.), prior to the completion of the collection of the balance of the regulated assets, the Company will collect the entire amount of the regulated assets in respect to the consumer package appearing above.

Note 3: Decisions of the Electricity Authority (cont.)

e. Principles for the supply of electricity to consumers

Pursuant to the Electricity Sector Law, one of the functions of the Electricity Authority is to determine criteria for service, in which are determined both the principles for the commitment between the consumers and the Company and the obligatory rates for the various services the Company supplies to its consumers. In August 2002, a service criteria book was initially published that replaced the majority of the provisions in the arrangement that existed until that time with principles for the supply of electricity to consumers that the Company published from time to time during the period the franchise was effective with the approval of the Ministry of Energy. In addition, the Electricity Authority determined the level of reliability lying at the rate base of the electricity, as follows:

1. The rate bases were intended to achieve a comprehensive level of reliability for the low-voltage consumer of an average of 100 minutes of supply failure to the average consumer annually ("the goal").

2. a. Until February 2003, the Electricity Authority will determine a plan obligating achievement of the goal (as of the date on which the financial statements were signed, such a plan has not yet been determined).
b. The Authority will not recognize investments in the DMS project (a project of the Company the intention of which is to improve the reliability of the electricity) that are not in the framework of the aforesaid plan that it will approve.

3. On the basis of the existing operations system, the Company is required to reduce the variation between the level of reliability in the various administrative regions and the general average from 100% to 50%.

In the Company's estimation, the changes in the criteria as they were published in the rate document, as opposed to the currently prevailing regulations for supplying electricity as they were included in the existing arrangement, there are no material implications for the Company. The Company's assessment is that it is meeting the aforesaid criteria, except for those detailed above and below regarding the determination of the level of reliability of supply.

As to the determination of the aforesaid level of reliability, the Authority has not yet determined a binding program to achieve the goal. The Company is acting to convince the Electricity Authority to accept its position that it will not be possible to implement the Authority's decision but that it is possible to achieve an annual level of overall reliability for the low voltage consumer of approximately 141 minutes of average non-supply to the average consumer (in 2005, an average of about 144 minutes of non-supply to a consumer were counted), only in the year following the completion of the DMS project that, according to the timetable, is due to end during 2010. The Company assumes that it will be able to achieve this target in those years when the weather will be average.

The Company is unable to estimate if its plan will be acceptable to the Electricity Authority and what would be the impact on the Company if the aforesaid targets that were determined by the Electricity Authority are not met, although it is possible that not meeting the target at the dates that will be determined in the plan, when they will be determined by the Electricity Authority, could be expressed by the non-recognition of certain costs in the distribution segment.

Note 4: Short-term Investments

	December 31, 2006	December 31, 2005
	NIS in millions	
Composed as follows:		
Short-term deposits	211	-
Basket certificates investing in shares in Israel and abroad	-	49
Debentures and government bonds	-	354
	211	403

Note 5: Trade Receivables for Sales of Electricity

	December 31, 2006	December 31, 2005
	NIS in millions	
Composed as follows:		
Customer debts in respect of electricity bills that were issued.	1,944	1,934
Reserve for doubtful accounts	(180)	(160)
	1,764	1,774
Income receivable(1)	1,107	1,069
	2,871	2,843

(1) Income in respect of the relative portion of the electricity bills issued after the balance sheet date that, according to an estimate, are attributable to the related reported period.

Note 6: Other Accounts Receivable - Unbilled

	December 31, 2006	December 31, 2005
	NIS in millions	
Composed as follows:		
Current maturities in respect of: (see Note 8)		
Loans to employees	29	35
Chartering of tugboats	6	5
Regulatory assets	-	384*
Swap transactions and deposits securing swap transactions	485	467
Total current maturities	520	891
Institutions	9	5
Prepaid expenses	29	34
Income receivable from insurance company	25	-
Natural Gas Lines Ltd.	55	-
Other receivables	36	40
Deferred taxes, net (See Note 19)	4	4
	678	974

* Reclassified.

Note 7: Inventory - Coal and Fuel Oil

	December 31, 2006	**December 31, 2005**
	NIS in millions	
Liquid fuel	910	1,088
Coal	379	176
Coal in transit	331	393
	1,620	1,657

Note 8: Long-term Receivables

a. Composition of long-term receivables:

	December 31, 2006	**December 31, 2005**
	NIS in millions	
Loans to employees (see section b below)	88	91
Chartering of tugboats (see section b below)	120	136
	208	227
Natural Gas Lines - gas transmission project (see Note 13.g below)	1,021	938
Receivables in respect to currency swap transactions (see Note 18 below)	15	166
Other swap transactions (see Note 23 below)	-	118
Deposits to secure swap transactions (see Note 23 below	485	349
Excess of amounts funded over accrual, net (see Note 17 below)	1,221	596
Regulatory assets (see Note 3.d below)	-	636
Other	3	2
Total long-term receivables	2,953	3,032
Less - current maturities (see Note 6 above)	520	891
	2,433	2,141

Note 8: Long-term Receivables

b. Loans to employees and chartering of tugboats

1. Linkage basis:

	December 31, 2006				December 31, 2005			
	Unlinked	**Linked to the CPI**	**Linked to the Dollar**	**Total**	**Unlinked**	**Linked to the CPI**	**Linked to the Dollar**	**Total**
	NIS in millions				NIS in millions			
Interest rates (in percentages)	2-6.12	4.5-5.1	7.89-8.37		2-6.12	4.5-5.1	7.89-8.37	
Loans to employees.	85	3	-	88	86	5	-	91
Chartering of tugboats	-	-	120	120	-	-	136	136
	85	**3**	**120**	**208**	**86**	**5**	**136**	**227**

2. Maturity dates:

	December 31, 2006		
	Loans to employees	**Chartering of Tugboats**	**Total**
	NIS in millions		
First year - current maturities	29	6	35
Second year	19	6	25
Third year	17	7	24
Fourth year	12	7	19
Fifth year	11	8	19
Sixth year and thereafter	-	86	86
Total	**88**	**120**	**208**

Note 9: Investments in Investee Companies

	December 31, 2006	**December 31, 2005**
	NIS in millions	
National Coal (see Note 13.a)		
Cost of shares	40	40
Accumulated profits	17	14
	57	**54**

a. The Company does not consolidate its financial statements with those of National Coal due to the lack of materiality. The investment in National Coal is presented on the equity basis (see also Note 13.a below).

b. The Company has inactive affiliated companies, where the balance of its investment in them is zero, as follows:
   1. Two wholly-owned affiliated companies, Jordan Investments Co. Ltd. and Migrashei Hakablanim Ltd. (an inactive company). The entire property of these affiliated companies is reflected in the assets of the Company.
      Jordan Investments Co. Ltd. has two wholly-owned inactive affiliated companies - Ma'abarot Hayarden Ltd. and the Palestine Construction Ltd.
   2. PAMA Ltd., in which the Company holds 49.99% of the share capital, which terminated its operations in 2000.

Note 10: Investments in Debentures

The investments in debentures reflect the Company's deposits in a trust account, which are intended to cover amounts funded for the termination of the employee-employer relationship (see Note 17 below).
It is composed of Government debentures that are presented at market value.

Note 11: Fixed Assets

	Cost		
	Balance on December 31, 2005	**Additions net**	**Balance on December 31, 2006**
		NIS in millions	
Fixed Assets in Use			
Power plants (including land, buildings and machinery)	45,823*	1,264	47,087
Switching and transformer stations	9,349	201	9,550
Overloading control center	714	14	728
Telecommunications	970	57	1,027
Switching stations and 400 KV line	6,384	89	6,473
High voltage transmission lines	4,467	100	4,567
Distribution networks	29,118	1,026	30,144
Installations and such East Jerusalem district	117	(3)	114
Meters	1,613	67	1,680
Land, office buildings	2,372*	98	2,470
Office equipment and tools	1,097*	28	1,125
Computers	3,049	248	3,297
Motor vehicles	550	(9)	541
Mobile mechanical equipment	468	(1)	467
Emergency equipment	47	1	48
Various projects	35	2	37
	106,173	3,182	109,355
Less: receipts for extension of the Electricity network	(7,710)	(6)	(7,716)
	98,463	3,176	101,639
Spare parts for power plants and substations	1,103	(23)(1)	1,080
Total fixed assets in use	99,566	3,153(2)	102,719
Fixed Assets Under Construction			
Investments in power plants and other Installations	5,305*	206	5,511
Switching and transformer stations and high voltage lines	738	203	941
Switching stations and 400 KV lines	225	(17)	208
Payments on account of equipment	353*	(264)	89
Materials and payments on account of materials designated for investments in fixed assets	506	(31)	475
Total fixed assets under construction	7,127	97(3)	7,224
Total fixed assets	**106,693**	**3,250**	**109,943**

* Reclassified.

Note 11: Fixed Assets (cont.)

Accumulated Depreciation			Net Book Value	
Balance on December 31, 2005	**Change in depreciation net**	**Balance on December 31, 2006**	**December 31, 2006**	**December 31, 2005**
	NIS in millions		NIS in millions	
23,624*	1,385	25,009	22,078	22,199*
4,238	307	4,545	5,005	5,111
620	23	643	85	94
648	57	705	322	322
1,959	209	2,168	4,305	4,425
2,084	114	2,198	2,369	2,383
13,796	804	14,600	15,544	15,322
117	(3)	114	-	-
1,159	60	1,219	461	454
1,008*	59	1,067	1,403	1,364*
893*	43	936	189	204*
2,365	263	2,628	669	684
303	(8)	295	246	247
393	7	400	67	75
30	3	33	15	17
12	2	14	23	23
53,249	3,325	56,574	52,781	52,924
(4,709)	(206)	(4,915)	(2,801)	(3,001)
48,540	3,119	51,659	49,980	49,923
272	11[(1)]	283	797	831
48,812	3,130	51,942	50,777	50,754
6	-	6	5,505	5,299*
30	-	30	911	708
1	-	1	207	224
-	-	-	89	353*
-	-	-	475	506
37	-	37	7,187	7,090
48,849	**3,130**	**51,979**	**57,964**	**57,844**

Note 11: Fixed Assets (cont.)

(1) Details of net additions - spare parts for power stations and substations:

	Year Ended December 31, 2006	
	NIS in millions	
	Cost	**Accumulated depreciation**
Purchases	91	-
Depreciation for the year	-	28
Disposals	(104)	(15)
Issuance to assets in use	(10)	(2)
	(23)	**11**

(2) Includes net disposals in respect to assets, as follows:

	Year Ended December 31, 2006
	NIS in millions
Cost	323
Accumulated depreciation	(231)
Net cost	92

(3) Details of net additions, projects under construction:

	Year Ended December 31, 2006		
	Fixed Assets Under Construction	**Inventory**	**Total**
	NIS in millions		
Total additions	1,086	531	1,617
Less: Transfer to assets in use (Gas turbines at Gezer 4 units and Zafit gas turbine)	(1,101)	-	(1,101)
Disposals	-	(19)	(19)
Transfer from inventory	143	(543)	(400)
Net addition - projects under construction	**128**	**(31)**	**97**

a. Investments in land (before amortization), which are included under fixed assets include NIS 592 million in respect of long-term leaseholds (until 2048) and NIS 604 million in respect of land owned by the Company.
A substantial portion of the landed property, in which the Company has rights, is not registered in the Land Registry and the status of such properties has not been settled for various technical reasons, such as the absence of parcelization in a portion of those areas, the requirements of planning authorities to arrange master plans, and disputes with the various authorities, including the tax authorities, regarding, mainly, properties which were acquired many years ago and registration changes, regarding the procurement of the certification about carrying out the debit payment, had been occurred, and those disagreements prevent the procurement of the certifications for registration in the Land Registry. Due to the complexity of the matter, it is not possible to estimate the period of time which will be required to conclude registering the land, but, in the Company's opinion, this cost of registering the land, as aforesaid, is not liable to be substantial.
With respect to the majority of the land leased by the Company from the Israel Land Authority, there are capitalized contracts.

Note 11: Fixed Assets (cont.)

b. As of the date of the expiration of the Concession (March 5, 1996), the Company had fully amortized the cost of land in the amount of NIS 485 million for which the Company's right to receive compensation at the expiration of the Concession was unclear. Land purchased in late 1995 at a cost of NIS 293 million, for which the Company received confirmation that it would receive adequate compensation, was not amortized. (See Note 1.a.4). The Company does not amortize the cost of land bought after the end of the Concession.

c. See Note 18.c for pledges related to fixed assets.

d. See Note 21.a.4 for fixed asset construction commitments.

e. Accumulated financial expenses, net, capitalized as part of the cost of fixed assets (before depreciation) were NIS 3,042 million and NIS 2,868 million as of December 31, 2006 and 2005, respectively (see Note 28.a).

f. The Company's financial statements include assets, primarily networks and lines located within Judea, Samaria and the Gaza Strip (including the Palestine Authority territories) ("the territories") with a net book value of approximately NIS 789 million as of December 31, 2006. In the opinion of the Company's management, the utilization of these assets for the purpose of electricity supply will continue and they will remain in the possession of the Company.

   In the event that the possession of the balance of the assets, as a whole or partially, located in the territories is taken from the Company, the Company's management estimates, based on the terms of the interim agreement signed between Israel and the Palestinians on September 28, 1995, and based on the principles prescribed in the disengagement law, that the Company will be indemnified in an amount equal to at least the net book value of the assets as reflected in the financial statements, and that the Company will not suffer losses as a result thereof.

   The Company has user's rights in the land and to what is connected to this land in the region of Gaza and northern Samaria (whose depreciated cost as of the balance sheet date amounted to about NIS 25 million) and from which Israelis were evacuated in accordance with the Law for the Implementation of the Disengagement Plan, 2005, that was passed in the Knesset on February 16, 2005 ("the disengagement law"). In accordance with the provisions of this law, the rights for the use of the land were nullified as of the date of the evacuation, while providing rights to demand compensation in respect to the infrastructure facilities that were installed by the Company. During the reported period, the Company filed a claim with the Disengagement Authority for compensation in respect to its assets that remained in the evacuated areas. In the Company's assessment the amount of the compensation, when it shall be received, will not be less than the value of the assets that are presented in its financial statements.

g. Pursuant to a directive from the Ministry of Infrastructures, new lease agreements will include a condition, pursuant to which, should the designation of the land cease serving its original objective (that is, electricity services), the agreement will be nullified and the land returned to the Israel Land Authority, while refunding the balance of the lease fees that were paid.

h. Based on an opinion of outside consultants, the Company studied the need for a provision for the impairment of value of its assets, which was based on Accounting Standard No. 15. This examination was performed even though the Company is studying the need for a provision for impairment of value pursuant to SFAS 71 (according to the recognition of assets for the purpose of rates, see Note 2.n. above).

   For the purpose of the work, three cash generating units were determined (generation, transmission and distribution) and a forecast was made of the future cash flows that are expected to result from these units, where this forecast was made based, among others, on assumptions that represent the economic conditions that will prevail during the useful life of the units' assets, of which the principal ones are:

   1. Coverage in the framework of the rate for the assets of the units according to their value in these financial statements.
   2. Coverage in the framework of the rate for the operating expenses expected for these units.
   3. Coverage in the framework of the rate for the fuel expenses the Company will bear.

Note 11: Fixed Assets (cont.)

4. The discount rate as of the balance sheet date, based on the CAPM model for calculating the return on shareholders' equity, and for determining the weighted discount rate (WACC). The weighted average cost of capital was calculated for the Company as one unit, and was split to cash generating units according to what exists in the current electricity rate for each cash generating unit, which is in respect to its being the general calculated discount rate that is very approximate to the capital cost recognized in the rate. The discount percentage rates are: 5.63% for a generating unit, 5.13% for a transmission unit, 5.36% for a distribution unit. These values, as aforesaid, reflect the time value of the money, and the specific risks for each cash generating unit.

In order to calculate the recoverable amount, the implications that are likely to stem from the decisions and letters of the Electricity Authority described above in Note 3.b., were not taken into account due to the reasons indicated in that Note.
Pursuant to the above calculations, it emerges that the recoverable amount for all of the assets of the cash generating units stated above as of December 31, 2005, is not lower than their value in these financial statements.

Note 12: Other Assets, Net

	Cost	**Accumulated Amortization**	**Net Book Value**	**Cost**	**Accumulated Amortization**	**Net Book Value**
	December 31, 2006			**December 31, 2005**		
	NIS in millions			NIS in millions		
Issuance and capital raising expenses due to long-term liabilities*	-	-	-	877	480	397
Issuance and capital raising expenses due to very long-term liabilities*	-	-	-	7	-	7
	-	**-**	**-**	**884**	**480**	**404**

* See Note 18 below.

Note 13: Related and Interested Parties

The State of Israel and companies and other entities controlled by it (such as Government companies, local councils and Government authorities) (and other corporations in which the Government has a certain percentage of ownership in them), constitute related and interested parties of the Company. The Company's income from those transactions carried out with interested parties, during its ordinary course of business, are: sales of electricity, electricity connections. In the framework of its purchases, the Company primarily buys from the above interested parties, natural gas transmission, water and land leasehold services. In the Company's opinion, payments to the State and its authorities as a sovereign entity, that is payments pursuant to law, such as taxes and fees, are not defined as transactions with interested parties.

a. Revenues

1. Revenues from the State and its authorities (in accordance with invoices that were issued, and not included income receivable) - NIS 497 million.
2. Revenues from interested and other parties - NIS 1,082 million (primarily revenues from Mekorot Ltd. - about NIS 529 million).

b. Expenses

1. Expenses in respect to natural gas transmission to Natural Gas Lines in Israel Ltd. ("Natural Gas Lines") - NIS 71 million (see section f below).
2. The remaining expenses (primarily leasehold fees, pumping of fuels and water) - about NIS 56 million.

With regard to State guarantees, see Note 18.g. below.

a. National Coal

National Coal is a subsidiary in which the Company holds 100% of the share capital aside from four shares that remained with the State so that there would remain a possibility for the state to take legal steps to restore money to National Coal.

1. On July 15, 2004, the Company signed an agreement with National Coal for the purchase and supply coal for the Company's power stations that consume coal - Orot Rabin at Hadera and Rutenberg at Ashkelon. The agreement is in force from December 31, 2003 and will be in force as long as the Company shall have generation licenses for the aforesaid power stations.
The Company reserves the right to cancel the agreement with one year's advance notice. The consideration that is paid is calculated based on cost in addition to an agreed upon profit and is subject to the coal price approved for the Company by the Electricity Authority.
In accordance with the aforesaid agreement, the ownership of the coal inventory is transferred directly to the Company from the supplier, where National Coal will continue to handle the shipment of the coal to the Company's power stations and appropriate insurance (in favor of the Company), in the case of loss or damage whatsoever to the coal.

2. In the year ended December 31, 2006, the Company received a dividend in the amount of NIS 5 million from National Coal (In 2005 - NIS 2 million).

b. State of Israel (chartering of tugboats)

In 1997, the Company chartered two tugboats that it had purchased from the Israel Shipyards Ltd., to the Hadera Port Authority for periods of twenty years each, pursuant to the charter agreement entered into between the Company and the Hadera Port Authority in 1995. The balance for the charter as of December 31, 2006 was approximately NIS 54 million. The amount is linked to the U.S. dollar with additional interest at customary rates (see Note 2.cc above).

Note 13: Related and Interested Parties (cont.)

c. The Eilat Ashkelon Pipeline Company Ltd. (hereinafter "EAPC")

Pursuant to an agreement between the Company and EAPC, EAPC allocated an area it owns to the Company for the purpose of building a pier for the unloading of coal for the Rutenberg power plant. In the context of this agreement, the Company entered into an agreement for the building of two tugboats by the Israel Shipping Ltd. In 2000, the tugboats were chartered to the Ashkelon port for periods of 204 months each, from the date of their delivery, in accordance with the charter agreement reached between the Company and EAPC. The balance of the amount of the charter fees as of December 31, 2006 was approximately NIS 65 million. The amount is linked to the U.S. dollar with additional interest at customary rates (see Note 2.cc above).

d. Oil Infrastructures Ltd.

Pursuant to an agreement between the Company and Oil Infrastructures Ltd., Oil Infrastructures constructed an oil distillate line ("the oil distillate line") to the Gezer site and, through which, oil distillates which are pumped for 50 years. In exchange for Oil Infrastructures' commitment to pump oil distillates through the line during the aforesaid period, the Company bears 64% of the value of the investment in the oil distillate line by way of the payment of 25 annual installments linked to the CPI. The Company recorded this transaction as a financial lease in the amount of approximately NIS 21 million.

e. The Israel Lands Authority

The Company reached an agreement with the Ministry of National Infrastructures and the Israel Lands Authority, pursuant to which, the Israel Lands Authority will allocate alternative land to the Company in respect to the land the Company vacated at the Reading C site for the purpose of a switching station, a substation, etc., in an identical area of land, one dunam for each dunam, at no cost, at a location required by the Company at its discretion, which was without accepting the Company's claim regarding its rights to the Reading C site. (The land at the Reading C site was depreciated in full - see Note 11b above.)
It was further determined that a negotiating team would be set up with the participation of representatives of the Company, the Israel Lands Authority, the Prime Minister's Office and budget division at the Ministry of Finance in order to determine the amount of compensation for the Company in respect to buildings at the site being vacated.
As of the date on which the Financial Statements were signed, the Ministry of National Infrastructures and the Israel Lands Authority had not yet finished carrying out their obligations to the Company.

f. Commitment for the transmission of natural gas

In June 2006, the Company and Natural Gas Lines signed an agreement for the transmission of natural gas according to the version published by the Natural Gas Authority, which is applicable to all gas consumers who enter into a transmission agreement with Natural Gas. The agreement is designed to regulate the commercial, technical and legal principles regarding natural gas transmission for a period of 15 years. In the context of the agreement between the Company, Natural Gas lines, the Natural Gas Authority and the Ministries of National Infrastructures and of Finance, and based on the decision of the board of directors, in October 2006, an addendum to the transmission agreement between the Company and Natural Gas Lines was signed, adding the following provisions:

1. Controversial issues regarding the transmission agreement will be discussed between the parties and the agreement will be amended according to the agreements reached between the negotiating parties. Any subject that is not agreed on by December 15, 2006 will be assigned to the decision of the general manager of the Ministry of Infrastructures for his final resolution.

2. The Company will have constitutional flexibility in exploiting the ordered gas capacity at a scope of 15%. The Electricity Authority approved the recognition of the Company's costs incurred from ordering such capacity (see Note 3.b.10 above).

Note 13: Related and Interested Parties (cont.)

f. Commitment for the transmission of natural gas (cont.)

3. Natural Gas Lines will allow the capacity ordering for spot transactions.

g. Project for the establishment of a natural gas transmission system ("the project")

In accordance with the agreement that was reached in November 2004, and the addendum to that agreement dated December 19, 2005, between Natural Gas Lines, the Government of Israel (on behalf of the State of Israel) and the Company ("the tripartite agreement"), it was imposed on the Company to finance, order and manage the jobs for establishing part of the natural gas transmission system in Israel as detailed below ("the project"). In addition, it was agreed that the Company will not serve as or be considered the head contractor or as the contractor carrying out the project, unless the aforesaid responsibility was imposed on the contracted by law. The project includes the establishment of a marine system for the transmission of natural gas, a marine segment from Ashdod to the Reading site, a reception terminal and metering terminal at Reading, a marine segment from Reading to the "Dor" coast, connection to the Hadera coast, including an overland segment from the Dor coast to the Hagit site and a reception terminal at the Hagit site.

The principal elements of the tripartite agreement are as follows:

- The Company's duties are to finance the project, to manage it and to order jobs that are related to its establishment (including, but without derogating from the totality of the aforesaid, the selection of contractors, the engaging of contractors, full coordination between the contractors regarding the carrying out of jobs and meeting the timetables, managing the carrying out and control of the jobs, taking those actions that are required in order to assure the existence and enforcement of the obligations of the contractors, to carry out all the actions that are required for the purchase and arrangement of all the rights in land that are required in order to establish the system, to obtain building and additional permits, as well as the handling and payment of compensation to the owners of the land and to do everything that is required to assure the integrity of the system during the warranty period).
- The Company will not be the owner of the system and it will not have any rights in it or in part of it, and the system shall be owned by the State.
- In exchange for carrying out the project, the Company will be entitled to receive all of the expenses (including financial expenses - as detailed in the tripartite agreement) that it expended for the project and that were approved by the authorized party, as was defined in the tripartite agreement (the accountant general at the Ministry of Finance, the director general of the Ministry of National Infrastructures and director general of Natural Gas Lines, hereinafter: "the authorized party"), as well as management fees in the amount of between $ 10 million and $ 14 million, such that the Company does not anticipate a material profit or loss from this project. The authorized party is entitled to offset from the expenses that shall be reimbursed to the Company any cost or damage that were sustained to the State and/or the Gas Line Company as a result of negligence or violation of the agreement by the Company. This liability of the Company is limited to $ 20 million during the warranty period, and $ 20 million following this period (even if the limits of the warranty period were fully or partially utilized). Should the damages that were caused by the Company's negligence exceed $ 20 million, the aforesaid surplus damages shall be offset against the management fees that are to be paid to the Company. Insurance was taken out for the project that covers damages that are likely to be caused to the project and damages that are likely to be caused to third parties. In addition, there is cover for the Company in respect to professional liability in the framework of the Company's general third party liability policy.

With regard to the reimbursement of the approved expenses, it was determined as follows:

1. Natural Gas Lines will pay all of the amounts to the Company that the Company must pay according to the clearing schedule ("the repayment amounts") in respect to the loans that the Company has received and will receive from Citibank for the financing of the project's costs (see below), which is on the date on which each payment was made for each of the repayment amounts according to the clearing schedule (back-to-back).

Note 13: Related and Interested Parties (cont.)

g. Project for the establishment of a natural gas transmission system (“the project”) (cont.)

2. The repayment amounts will also include effective payments by the Company to the State for guarantee commissions and other commissions and expenses that the Company paid for taking out the aforesaid loan.

The settling of accounts regarding the approved expenses and the reimbursement shall be denominated in U.S. dollars. The Company’s responsibility for the project is derived from the liability and the duties imposed on it in the tripartite agreement. In addition, this duties are liable to impose on it responsibility by law, including responsibility pursuant to the labor safety laws.

The Company’s responsibility regarding the integrity of the system, as defined in the tripartite agreement, is limited to the warranty period, which is provided to the Company by the contractors with which it entered into agreements, and on condition that it will not be less than the minimal period detailed in the agreement - up to the end of 18 months from the date on which confirmation was granted for the completion, or by the end of 12 months from the date on which the system began to operate, whichever is earlier. (Nonetheless, it should be pointed out that the Company does not receive any general warranty for the system from the contractors; rather, each contractor is responsible only for the work he carried out).

In January 2005, the section of the pipe in the sea suffered damage. This damage was repaired by the supplier in light of his warranty, in accordance with the agreement between him and the Company. In the Company’s opinion, the repair was successful, and the Company has confirmation to that effect from regulatory bodies. While the repair was being made, Natural Gas Lines directed the Company to repair it differently. However, consenting to these requests would have resulted in an additional expense of tens of millions of dollars, not to mention the fact that the Company was instructed by the Minister to make the repair as it was carried out. Should the Company be required in the future to make the repair by a different method, the expected expense will be about $ 30

Regarding the manner for repairing the damage to the line, in the Company’s assessment the possibility that the Company will be required to make the repair a second time by another method is theoretical and the Company does not believe that it will materialize.

In the reported period, several controversial issues were raised between the Company and representatives of the State regarding the project as follows:

a) On April 10, 2006, the authorized body rejected several requests made by the Company to increase the project’s budget in connection with jobs already expenses by it or that will be expensed in the future, amounting to about $ 20 million.

b) In addition, it is the authorized body’s opinion that expenses relating to the project that had been or will be expensed by others in a total of about $ 10 million should be borne by the Company.

c) Furthermore, certain claims were raised against the Company by the Ministry of Defense arguing that the Company had violated its obligation to place the gas pipe at a certain depth as specified in the above claims.

Based on the opinion of its legal counsel, the Company believes that as far as issues a) and b) above are concerned, it has solid arguments based on which it is highly likely that the Company will be awarded the amounts that it had expensed or had committed to spend in respect of additional jobs and tests at the gas pipe. Nevertheless, it should be noted that the Company has not yet received information regarding the specific claims raised by the authorized body and their references, if any, and no legal proceedings have been initiated by any of the parties.

Note 13: Related and Interested Parties (cont.)

g. Project for the establishment of a natural gas transmission system ("the project") (cont.)

With respect to issue c) above, other than the fact of raising the claim by the Ministry of Defense, no specific claims have been made by the Ministry and certainly no claims have been made regarding damages or the demanded repair costs. Therefore, despite tests conducted by the Company's technical staff, it is difficult to assess the Company's exposure, as it may be. It should be clarified that the Company is continuing its preparation for the arbitration proceeding as above and, with the help of technical factors, is examining the statements made by the project's managers.

Furthermore, the Company has addressed the Attorney General requesting to nominate arbitrators (legal and technical) to discuss the various disputes between the Company, the State and other factors in connection with this project. Until the date of signing the financial statements, said arbitrators have not been appointed. A provision of NIS 30 million was included during the reported period.

h. Letter of indemnification to the State of Israel

The Company furnished a letter of indemnification to the State of Israel (the Ministry of Defense) in connection with the damages likely to be caused to the State subsequent to the gas transmission line passing through security areas that belong to the State, and the Company's liability for indemnification to the Ministry of Defense in respect to any damage. An expense, payment or loss that will be borne by the Ministry of Defense as a result of the laying of a submarine pipe that is not in accordance with the provisions of the coordination agreement that was signed with the Ministry of Defense in this respect. The force of the letter of indemnification has expired and, as of the date on which these Financial Statements were signed, the Company is not aware of any event whatsoever that is liable to establish responsibility and/or liability in accordance with the letter of indemnification.

i. Establishment of a desalination facility at the Orot Rabin site

On September 7, 2004, an agreement was signed between the State and the Company, pursuant to which the Company will, on the date of commencement of the construction of a desalination facility or any other date according to what is determined by the Government, place at the State's disposal the right for the use of land with an area of about 71 dunams in the area of the Hadera power station, for the purpose of constructing a sea water desalination facility. The right of use of the land extends for 24 years and 11 months. In consideration for granting the aforesaid use of the land, the Company is entitled to a non-recurring sum of $ 1.5 million for covering the costs of evacuating the buildings on the designated plot that were to be assigned to the concessionaire and relocating to another place at the power station as well as an amount of $ 240 thousand per year, beginning as of the date on which the facility is built. For additional services to be provided by the Company to the operator, it will be entitled to a payment of 0.24 cents for each one cubic meter of desalinated water that the operator will sell to the State (the facility is intended to supply about 100 million cubic meters of desalinated water a year). As of the date on which these financial statements were signed, the rights for the use of the land had not yet been transferred to the State.

Note 13: Related and Interested Parties (cont.)

j. The Study Fund of the Israel Electric Corporation Employees Ltd. (the Study Fund")

The Company holds 50% of the Study Fund's management shares and rights to nominate directors (excluding a right to share profits). The Company makes deposits in the Study Fund in respect of the employees entitled to such deposits pursuant to labor agreements. Following are the amounts funded during the periods:

	NIS in millions
For the year ended December 31, 2006	69
For the year ended December 31, 2005	65

The Study Fund does not invest in the Company's securities.

k. Benefits paid or accrued for the account of interested parties

Group	Year Ended December 31,			
	2006	2005	2006	2005
	Number of Individuals		NIS in millions	
1. Interested parties employed by the Company (including directors employed during part of the year)	2	2	1.4*	1.4
2. Directors not employed by the Company*	12	13	0.7	0.6

* The Chairman of the Board retired on August 9, 2006. No new paid Chairman was appointed by December 31, 2006.

Note 14: Credit from Banks and Others

	December 31, 2006				December 31, 2005			
	Not linked	Stated in or Linked to Foreign currency	Linked to the CPI	Total	Not linked	Stated in or Linked to Foreign currency**	Linked to the CPI	Total
	NIS in millions				NIS in millions			
Interest rate (%)					7%			
Overdrafts	-	-	-	-	19	-	-	19
Current maturities of loans and debentures*	1,756	(1,448)	2,395	2,703	-	2,760	580	3,340
For forward transactions	2,065	(3,480)	1,513	98	1,033	(876)	-	157
Total	**3,821**	**(4,928)**	**3,908**	**2,801**	**1,052**	**1,884**	**580**	**3,516**

* With respect to interest rates for current maturities, see Note 18.

** As for currency types, see Note 18.

Note 15: Customer Advances, Net of Work in Progress

Customer advances, net of work in progress, represent the advances received from customers, net of work in progress in respect of connections to buildings and work paid for by others.

	Connections to Buildings December 31,		**Work Paid for by Others December 31,**		**Total December 31,**	
	2006	**2005**	**2006**	**2005**	**2006**	**2005**
	NIS in millions		NIS in millions		NIS in millions	
Receipts from customers	126	112	564	481	690	593
Less: expenses in respect of work in progress	71	65	371	380	442	445
	55	47	193	101	248	148
Deductible in respect to insured damages	-	-	22	12	22	12
	55	**47**	**215**	**113**	**270**	**160**

Note 16: Accounts Payable and Credit Balances

	December 31, 2006	**December 31, 2005**
	NIS in millions	
Employees.	314	404
Institutions	208	227
Interest and accrued expenses	1,098	994
Current maturities of accrued pension and severance liability (Note 17)	37	33
Regulatory liabilities (Note 3.d)	680	148*
Other current liabilities	160	80
	2,497	**1,886**

* Reclassified.

Note 17: Liabilities Incurred through Employee-employer Relations, Net

	December 31, 2006	December 31, 2005
	NIS in millions	
Deposits in the framework of the Company's pension plan		
Pension deposits deposited in the central provident fund for pension pay	16,865	15,451
Less: amounts funded in the central provided fund for pension pay	(15,746)	(14,056)
Balance to be deposited	1,119	1,395
Additional deposits in respect to retirement of employees	1,533	1,270
	2,652	**2,665**
Actuarial losses not yet recognized (see Note 2.q above)	(3,873)	(3,261)
Total deposit for pension pay and pension grants in the framework of the Company's pension plan, net	**(1,221)**	**(596)**
Other deposits		
Pension grants to employees	163	148
Grants for non-utilization of sick leave allowance and others	386	350
Severance pay to employees under a special contract	41	52
Vacation pay	159	154
Total other deposits	**749**	**704**
Total deposits, net	**(472)**	**108**
Presented as follows:		
Current liabilities - various receivables	37	32
Long-term liabilities - long-term liability incurred through employee-employer relations, net	712	671
Long-term debts	(1,221)	(595)
Total deposits, net	**(472)**	**108**

a. The company's pension plan

1. Amounts funded

a) Summary of the Company's pension regulations, the salary components for calculating the pension and the principal actuarial assumptions applicable to the Company's permanent employees that were hired until June 12, 1996 ("the employees in the pension plan")

The pension regulations that apply to all of the Company's employees that are included in the pension plan. The pension regulations apply to the Company's permanent employees. Pension rights result from one of the following:

1) Compulsory retirement that, by law, was fixed at the age of 67.
2) After at least 30 years of service and minimum age of 55 (women - 50 years), and he wishes to retire, or that the Company is interested in his retiring, and the workers committee agrees, and on condition that the general number of those retiring according to this article in any year whatsoever will not exceed 20% of the entire retirees in that year. However, if an employee should wish to retire in accordance with this article and the Company shall be interested in his continued employment, the Company shall take into account the workers committee's recommendation.
3) Dismissal after at least ten years of service and minimum age of 40.
4) Disability retirement.
5) Survivors of workers/pensioners are entitled to rates of pension as detailed in pension regulations.

Note 17: Liabilities Incurred through Employee-employer Relations, Net (cont.)

a. The company's pension plan (cont.)

1. Amounts funded (cont.)

- Pension rates:
  a) After 10 years of service - 25% of last salary.
  b) After each additional year of service, up to 30 years - 2% of last salary for each additional year.
  c) From the 31st to the 35th year of service - 1% of the last salary for each additional year.
  d) For over 35 years of service, the employee receives on retirement, his last year's monthly salary for each year of service exceeding 35 years.
  e) For disability retirement of a permanent employee the rates of pension will be determined in accordance with the pension regulations.

b) In order to evaluate the liability for the pension for the Company's employees, the Company uses actuarial calculations prepared by an independent outside actuary (in the amount of about NIS 18,150 million at balance sheet date). The liability calculation is made using personal data of permanent employees who are entitled to a pension and that is supplied to the actuary and, in addition, the Company includes components in its liabilities for pension in the amount of about NIS 248 million.
The evaluation of the actuarial liability is based on a forecast of future expected cash flows according to a system of actuarial assumptions. In effect for better or for worse, these cash flows are likely to be different from what is expected due to the possible difference between the actual future reality and the forecasts. Also the system of assumptions on which the actuarial balance sheet is based is subject to changes that are likely to occur to it in the future, such that - with the accumulation of updated information in respect to factors that have an effect on the continued force of these assumptions. For example: changes in the development of life expectancy, regulatory changes, economic changes, etc. Such possible changes will (on their occurrence) affect the amount of the liability for the employee-employer relationship.

The following are the main assumptions according to which the actuarial liability is calculated:

1) The liability is calculated for the pension salary components included in the last wages as of the date of the financial statements with the addition of a provision of 0.5% in respect of the salary agreement for 2005 not yet paid as well as another 1% based on management's assessment (based on past experience) in respect of the expected future salary agreement for 2006.
2) The liability is calculated on the basis of the life tables published by the capital markets insurance and savings division of the Ministry of Finance, which includes a future dynamic improvement in life expectancy. On October 17, 2004, the capital market, insurance and savings division at the Ministry of Finance ("the capital market division") published interim results of a study that was made, pursuant to which the rate of increase in lifespan is greater than what was assumed in previous calculations. According to what was stated in the publication, the study is not final and, in the future, it is possible that there will be changes and adjustments.
3) The actuarial liability takes into account severance pay (according to law) whose future effects on the funded amounts are not material.
4) Until the actuarial evaluation in the financial statements of September 2006, the liability was calculated according to the forecasted increase in employees' wages based on a personal wage scale, both according to age and gender, and according to estimated general increase in wages. According to the Company's evaluation, the rate of the general (real) annual increase in wages was 1% in excess of the increase in the personal wage scale (a rate that reflects the Company's future wage policy, the assumptions of the Ministry of Finance for pension funds are the use of a real annual wage increase of 2%, which is the average rate of increase for the market), and for those employees following their retirement, the liability was calculated based on a real increase in pension of 2% annually.
The Company's actuary conducted a study based on the salary data for the last 15 years, measured separately according to gender and age and based on a combination of cross and vertical sections.

Note 17: Liabilities Incurred through Employee-employer Relations, Net (cont.)

a. The company's pension plan (cont.)

1. Amounts funded (cont.)

The study's findings led the Company's actuary to the conclusion that the salary growth model, based on personal growth accompanied by general growth, as above, is not appropriate for the Company. He believes the salary growth graph should be determined based on the total salary growth including both personal and general growth. This reassessment has led to an increase in the actuarial liability as of balance sheet date totaling approximately NIS 35 million. The assumption underlying the pension growth rate for pensioners has not changed.

5) The interest rate for the capitalization of the liability is determined in accordance with what is published by Interest Rates Company Ltd. that is determined based on the return for redemption of the Government debentures.

6) The liability is calculated pursuant to the compulsory retirement age of 67 for men and women, and in accordance with the actuarial guidelines for retirement prior to the above ages (such as: disability, early retirement and death), and in respect to the early retirement of employees under special terms, the actuarial assumption is based on the Company's decision that in future years, no more that 40 employees per year will retire in this framework.

7) The liability is accrued uniformly (linearly) over the expected term of the employees' employment.

2. Deposits

Central Provident Fund for Pension Pay

a) On March 8, 2005, the Company began to transfer the cash which until that date were invested in a trust account and which were designated for covering the liability for pension of the employees under the pension plan, to the Central Provident Fund for Pension Pay ("the fund").

b) The fund operates by force of the Income Tax Regulations (Principles for Approving and Managing Pension Funds), 1964 (hereinafter: "the income tax regulations"). The fund is also managed by the management company (hereinafter: "KFI") in accordance with directives of the capital market, insurance and savings division, the directives of the fund's code and provisions of the agreement for management services between the Company and KFI Ltd. and its shareholders.

c) The fund calculates the Company's actuarial liability for employees in the pension plan in order to determine the amount that must be deposited by the Company to cover this liability. The fund's actuary makes these calculations according to what is stated in income tax regulations referred to above, which prescribe that the amount of the liability will be calculated in respect to the qualifying wage components, in the manner indicated by the supervisor of the capital market at the Ministry of Finance ("the supervisor"), in accordance with the Company's liabilities, pursuant to the applicable labor agreements and according to all law. Among others, the calculation will refer to interest rate for capitalization, the rate of interest for the qualifying wage components, the method for linking the allowances and the mortality tables.

The Company's current deposits with the fund must reach the amount of its actuarial commitment; however, it is possible to deposit the amounts within 90 days or within 12 months, according to the changes that were used for the purpose of the deposits with the fund.

d. Based on the fund's calculations, the Company's actuarial liability amounts to about NIS 16,865 million.

e. The actuarial assumptions according to which the fund calculates the amount of the Company's actuarial liability are principally similar to the Company's actuarial assumptions. Should the Supervisor instruct the fund to modify a certain actuarial assumption, there may be a gap between the liability presented in the Company's financial statements and the amount the Company is required to deposit in the fund.

Note 17: Liabilities Incurred through Employee-employer Relations, Net (cont.)

a. The company's pension plan (cont.)

3. The amounts of the pension expenses that were included in the salary and pension pay costs for the reported year, are as follows:

	2006	2005
	NIS in millions	
Current service cost	394	292
Interest on the liability	630	340
Expected return on the deposits	(573)	(297)
Actuary losses that were written down	218	161
Expenses that were included in the cost of salary and pension pay	**669**	**496**

4. The amounts deposited cover all of the Company's liabilities toward its employees under the pension plan, assuming that the employees will retire according to generally accepted actuarial estimates.
In the event all of the employees under the pension plan should be dismissed immediately, the amount of the liability to these employees will be significantly greater that the amount of the liability that is presented in the financial statements. In the assessment of the Company's management, a situation like this is not expected.

b. Pension for employees not under the pension plan

The Company's other employees, who are not included in the pension plan, are insured by a comprehensive pension through a new cumulative outside pension fund, up to the cap amount permitted by law, and by a provident fund for pension with respect to the other relevant components. The Company deposits its full liabilities in respect to these employees.
The amounts that are deposited in the aforesaid pension fund, are recorded in the name of the employee, and the liabilities in their respect are not presented in the Company's balance sheet, since they are not controlled or managed by the Company.

c. Other reserves

1. Retirement grants
An employee who has served for 10 to 35 years is entitled, on his retirement (compulsory, voluntary or disability), to a grant of 10% for each year of service multiplied by his last salary.
The Company currently accrues the employees' entitlements in accordance with the above formula, relative to their service in the Company.

2. Compensation for non-utilization of sick leave allowance and others
Compensation for non-utilized sick leave allowance, which comprises the material part of this liability category, is paid to employees who are retiring based on their last salary for the sick leave, as follows:

- An employee who utilizes during the period of employment in the Company less than 36% of all sick leave days such employee is entitled to, will be compensated at the rate of 26.66% of the balance accumulated during the period of employment.
- An employee who utilizes during the period of employment in the Company between 36% and 65% of all sick leave days such employee is entitled to, will be compensated at the rate of 20% of the balance accumulated during the period of employment.
- An employee who utilizes more than 65% of all sick leave days will not be compensated.

Note 17: Liabilities Incurred through Employee-employer Relations, Net (cont.)

c. Other reserves (cont.)

3. Severance pay to employees under special contract
The Company is obligated to pay severance pay to employees who are not included in the framework of the Company's pension plan, and in whose respect the Company transfers to the pension funds a portion of its liabilities in respect of severance pay.
The liability is calculated based on the employees last salary as of the balance sheet date, and presents the Company's total liability according to the Severance Pay Law or other agreements, which exceeds the amounts credited to the employees in external pension funds.

d. Funded amounts in trust

To cover the various deposits, which the Company does not make deposits in their respect with the Central Provident Fund for Pension Pay, because of the Fund's charter, the Company deposits funds in a trust account (see Note 10 above)

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net

a. Composition of the long-term and very long-term debentures and liabilities and swap transactions, net

	December 31, 2006		
Linkage Basis:	**Unlinked NIS**	**Linked to the CPI**	**In U.S. Dollars**
		NIS in millions	
(1) Debentures	8.5	2.5-6.5	7.0-8.9
Interest rates (%)*	8.3	3.8-5.7	7.5-11.4
Effective interest rates (%)			
Debentures traded on the Israel Stock Exchange (1)	-	6,494	-
Debentures not traded in Israel	591	3,850	-
Debentures issued abroad	-	-	11,175
	591	10,344	11,175
Less: deferred charges	-	(28)	(32)
(Discount)/Premium expenses	43	888	(32)
	634	11,204	11,111
Current maturities:			
Debentures	-	133	951
Deferred charges	-	(4)	(6)
(Discount)/Premium	3	92	(5)
	3	221	940
Total of long-term debentures, net	631	10,983	10,171
Very long-term debentures issued in the United States	-	-	528
Less: Deferred charges	-	-	(6)
(Discount)	-	-	(1)
Very long-term debentures, net	-	-	521
Total debentures, net	**631**	**10,983**	**10,692**

* See Note 14 above.

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

a. Composition of the long-term and very long-term debentures and liabilities and swap transactions, net (cont.)

December 31, 2006					December 31, 2005
In Euro	In Swiss Francs	In Japanese Yen	In Other Currencies	Total	Total
NIS in millions					NIS in millions
		2.8-4.1			
		3.3-4.4			
-	-	-	-	6,494	9,293
-	-	-	-	4,441	-
-	-	3,020	-	14,195	17,102
-	-	3,020	-	25,130	26,395
-	-	(29)	-	(89)	-*
-	-	(7)	-	892	775
-	-	2,984	-	25,933	27,170
-	-	-	-	1,084	1,743
-	-	(3)	-	(13)	-*
-	-	-	-	90	70
-	-	(3)	-	1,161	1,813
-	-	2,987	-	24,772	25,357
-	-	-	-	528	574
-	-	-	-	(6)	-*
-	-	-	-	(1)	(1)
-	-	-	-	521	573
-	**-**	**2,987**	-	25,293	25,930

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

a. Composition of the long-term and very long-term debentures and liabilities and swap transactions, net (cont.)

	December 31, 2006		
Linkage Basis:	**Unlinked NIS**	**Linked to the CPI**	**In U.S. Dollars**
		NIS in millions	
Brought forward from previous page	**631**	**10,983**	**10,692**
(2) Liabilities to banks			
Interest rates (%)*	3.3-5.4	5.5-7.4	3.8-6.2
Effective Interest rates (%)	3.5-5.7	6.2-8.3	4.2-6.6
Loans from banks	-	1,015	6,832
Less: Deferred charges	-	-	(63)
	-	1,015	6,769
<u>Current maturities:</u>			
Loans from banks	-	149	338
Less: Deferred charges	-	-	(7)
	-	149	331
Bank Liabilities, net	**-**	**866**	**6,438**
(3) Other long-term liabilities			
Interest rates (%)*		2.7-6.8	7.7-8.1
Effective interest rate (%)		2.7-6.8	7.4-8.5
Loans from provident funds and insurance companies	-	1,944	249
Loans from suppliers	-	-	22
Liabilities from financed leases	-	22	-
Total	-	1,966	271
Less: deferred charges	-	(4)	-
	-	1,962	271
<u>Current maturities:</u>			
Other long-term liabilities	-	169	17
Less: deferred charges	-	(1)	-
	-	168	17
Other long-term liabilities, net	**-**	**1,794**	**254**
Total debentures and liabilities, net	**631**	**13,643**	**17,384**

* See Note 14 above.

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

a. Composition of the long-term and very long-term debentures and liabilities and swap transactions, net (cont.)

December 31, 2006					December 31, 2005
In Euro	In Swiss Francs	In Japanese Yen	In Other Currencies	Total	Total
NIS in millions					NIS in millions
-	**-**	**2,987**	**-**	**25,293**	**25,930**
2.7-4.2			5.8-5.7		
3.1-6.2			6.6		
4,884	97	-	35	12,863	13,390
(184)	-	-	-	(247)	-
4,700	97	-	35	12,616	13,390
637	37	-	7	1,168	1,228
(34)	-	-	-	(41)	-*
603	37	-	7	1,127	1,228
4,097	**60**	**-**	**28**	**11,489**	**12,162**
4-5.9					
4.1-5.2					
-	-	-	-	2,193	2,439
211	-	-	-	233	307
-	-	-	-	22	23
211	-	-	-	2,448	2,769
-	-	-	-	(4)	-*
211	-	-	-	2,444	2,769
53	-	-	-	239	298
-	-	-	-	(1)	-
53	-	-	-	238	298
158	**-**	**-**	**-**	**2,206**	**2,471**
4,255	**60**	**2,987**	**28**	**38,988**	**40,563**

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

a. Composition of the long-term and very long-term debentures and liabilities and swap transactions, net (cont.)

	December 31, 2006		
Linkage Basis:	**Unlinked NIS**	**Linked to the CPI**	**In U.S. Dollars**
		NIS in millions	
Brought forward from previous page	**631**	**13,643**	**17,384**
(4) Swap transactions			
Deposits	-	-	(8,718)
Loans	4,126	3,926	254
Total swap transactions	4,126	3,926	(8,464)
Forward transactions	2,037	-	852
Total hedging transactions	6,163	3,926	(7,612)
Current maturities of swap transactions	1,753	1,906	(3,155)
Current maturities of forward transactions	2,037	-	852
Total current maturities	3,790	1,906	(2,303)
Total hedging transactions, net	**2,373**	**2,020**	**(5,309)**
Total debentures, liabilities and swap transactions, net	**3,004**	**15,663**	**12,075**
Transfer of swap transactions to long-term debts, net (see Note 8)	-	-	15
Total	**3,004**	**15,663**	**12,090**

* See Note 14 above.

1. Series 19-22 of debentures which were issued on the Tel-Aviv Stock exchange, are linked (principal and interest) to the known CPI, and are due for redemption through the years until 2015.

2. During the reported period, the Company issued non negotiable L and M debentures payable in 2017. In the framework of these series, debentures were issued at a nominal value of NIS 1,793 million, at annual interest of 6.5% and 8.5%, respectively. The proceeds from the aforesaid raisings net of issuance expenses (in the amount of NIS 191 million) amounted to NIS 2,012 million.

3. Debentures issued to insurance companies are linked (principal and interest) to the CPI. This linkage is fully insured by linkage insurance approved by the Accountant General for a premium payable by the Company equal to 6% per annum on the outstanding nominal principal amount. Accordingly, the linkage receivable from the Government has been offset against the related payable (as of December 31, 2006 approximately NIS 0 million). The debentures were repaid on January 1, 2007.

   As collateral for the payment of the debentures, the Company granted a fixed charge on a plot of land in favor of the insurance companies. The Company has applied to the beneficiary of the charge to receive its consent to remove the charge from the Companies Registrar.

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

a. Composition of the long-term and very long-term debentures and liabilities and swap transactions, net (cont.)

December 31, 2006					December 31, 2005
In Euro	**In Swiss Francs**	**In Japanese Yen**	**In Other Currencies**	**Total**	**Total**
NIS in millions					NIS in millions
4,255	**60**	**2,987**	**28**	**38,988**	**40,563**
(927)	(97)	-	(459)	(10,201)	(9,133)
1,615	-	-	1,369	11,290	9,351
688	(97)	-	910	1,089	218
(927)	-	(1,715)	(167)	80	157
(239)	(97)	(1,715)	743	1,169	375
-	-	-	(330)	174	(47)
(927)	-	(1,715)	167	80	157
(927)	-	(1,715)	(497)	254	110
688	**(97)**	**-**	**1,240**	**915**	**265**
4,943	**(37)**	**2,987**	**1,268**	**39,903**	**40,828**
-	-	-	-	15	166
4,943	**(37)**	**2,987**	**1,268**	**39,918**	**40,994**

b. Maturity dates subsequent to the balance sheet date are as follows:

	Debentures	**Liabilities to banks**	**Other liabilities**	**Total**
	NIS in millions			
First year - current maturities	1,084	1,422	239	2,745
Second year	39	1,199	223	1,461
Third year	4,686	1,000	215	5,901
Fourth year	252	1,023	170	1,445
Fifth year	3,100	1,340	94	4,534
Sixth year and thereafter	16,498	8,311	1,258	26,067
	24,575	12,873	1,960	39,408
	25,659	**14,295**	**2,199**	**42,153**

The payments that mature in subsequent years are on account of the principal and linkage only.

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

c. To secure the full and proper payments of the aforementioned debentures (principal, interest and linkage differences) and to secure proper compliance with the other terms of the debentures, the Company granted a floating charge on all its assets (including fixed assets under construction) and its rights to those assets of any type and sort whatsoever, which it currently owns or will own in the future, ranking equally (pari passu) with all other floating charges granted by the Company proportionately to the amounts of liabilities which will be secured, from time to time, by each of these charges.

At the time the fixed assets under construction for which a generation license must be obtained are operated, the Minister is entitled to determine restrictions with respect to the transfer, encumbrance or attachment of that asset (see also Note 1.a.3.b). The Company is of the opinion that these restrictions can not apply to existing encumbrances.

d. The fair value of the debentures traded on the Israel Stock Exchange is approximately NIS 7,287 million. This sum reflects the market value of these debentures on the balance sheet date. As to the fair value of other debentures, see Note 23.c below.

e. In addition to the charge stated above in section c, the lenders were granted the right to offset or place a lien regarding all of the cash, notes, securities and other negotiable instruments that the Company delivers to them for collection, security, safekeeping or other activities.

f. **The conditions in the Company's loans agreements that are liable to result in immediate repayment**

1. According to the loans agreements, the Company is not required to comply with any financial covenants whatsoever. Nonetheless, there are general provisions in the loans agreements that provide the lender with the right to demand immediate repayment of the loan on the occurrence of an event where, in the lender's opinion, there is something that could materially adversely affect the Company's ability to repay the loan.

2. As is customary in loan agreements, events such as a material violation of the Company's liabilities, the granting of a liquidation order or the appointment of a receiver for material assets of the Company, provide the lenders with the right to demand immediate repayment. When such events occur, a lender in whose favor the Company recorded a floating charge is entitled to realize his charge.

3. The conditions of the loan agreements are not identical. As is common for such agreements, loan agreements include one or more of the events detailed in them as events that enable the lenders to demand immediate repayment.

4. All loan agreements with foreign lenders are subject to the laws of foreign states, such as the U.S., England, Germany, Switzerland, Canada, France, etc., and the courts in those countries have the exclusive authority to hear and decide disputes between the parties, except for the authority to hear and decide claims with respect to the realization of charges that the Company recorded in favor of the lenders, which is exclusively provided to the District Court at Haifa. The law in Israel applies to all charges. The Company is unable to estimate how the court in a foreign state will relate to the provisions of these loan agreements.

5. In all loan agreements, not paying the principal or interest on time (or after a period of the deferment of the repayment as defined in the agreement) constitutes a breach that provides the lender with the right to demand immediate repayment. In all loans agreements denominated in foreign currency, the Company is obligated to pay the principal and interest in the denominated currency. The Company's inability to purchase foreign currency at the required time and in the required amount constitutes a breach that provides the lender the right to demand immediate repayment.

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

f. The conditions in the Company's loans agreements that are liable to result in immediate repayment (cont.)

6. In most loan agreements, if the Company shall breach its liabilities toward a certain lender as a result of this breach, where the cash value exceeds a certain amount defined in the agreement, and that lender demands immediate repayment as a result of that breach, the matter will result in a "cross violation", whereby a lender with whom an agreement was not breached is entitled to demand immediate repayment. The majority of the loan agreements determine that nonpayment pursuant to a ruling against the Company in excess of a certain amount (in the majority of cases, $ 25 million or more) provides the lender with the right to demand immediate repayment. Here as well, the reference is to a cross violation clause.

7. In all loans agreements where the Company's liabilities are secured by a State guarantee, the cancellation of the State guarantee or the insertion of changes to the guarantee without the lender's consent constitutes a breach that provide the lender with the right to demand immediate repayment.

8. The transfer of Company assets: In part of the loans agreements, there is a blanket prohibition against the transfer of assets that are the subject of the specific loan. In other loan agreements, the Company has the right to transfer assets subject to conditions/restrictions included therein, including obtaining the lender's consent. Certain agreements allow the transfer of assets to subsidiaries of the Company, on condition that these assets constitute less than 5% of the Company's assets. Certain loan agreements prescribe that the Company is entitled to transfer assets on condition (1) that the transfer is at market value (according to the determination of an appraiser or the Company), (2) at least 75% of the proceeds was received in cash or cash equivalents, (3) that the Company shall invest the proceeds in active assets. In the framework of the capital raisings plan in the U.S. ("the capital raisings plan"), the Company is entitled to use the proceeds in order to pay part of the amounts it owes to the holders of debentures that were issued in the framework of this plan.

9. The transfer of the Company's liabilities: In part of the loans agreements, the Company was provided the right to transfer its liabilities that are the subject of the loan, subject to the receipt of the lender's consent. It should be pointed out that pursuant to Israeli law, it is not possible to assign a charge without the creditor's consent. An action by the Company contrary to these provisions constitutes a breach that provides the lender with the right to demand immediate repayment.

10. In the majority of loan agreements, the Company has exhibited presentations of various matters, such as the accuracy of its financial statements, its right to use its assets and/or its ownership of them, the existence of the required licenses and their renewal on time, etc. In a case where it will be determined that the Company's representations were materially misleading (or incomplete), the lender has the right to demand immediate repayment. In addition, nondisclosures of material details that are liable to result in a materially adverse change in the Company's business activities or its ability to repay provide the lender with the right to demand immediate repayment.

11. In certain loan agreements, the Company is obligated to provide the lender with current updates regarding events (including a change in legislation and decisions by the Government, and including structural changes in general) that affect or are likely to adversely affect the Company's operations and/or financial strength. The lender is granted the right to decide, at his discretion, if there is anything to these changes in order to risk the Company's ability to repay the loan (principal and interest). Should the lender decide that that is the case, he is provided with the right to demand immediate repayment.

12. In the framework of the debentures that the Company issued to the public and institutional investors in Israel, beginning with the debentures (Series 19) through the debentures (Series 21) inclusive, it was determined in the trust deeds that the Company will be entitled to sell, lease, assign, deliver or transfer, in any other way, its assets, or any part of them, during the ordinary course of business. Carrying out an action not in the ordinary course of business could provide the lenders (through the trustees) the right to demand immediate repayment.

Note 18: Long-term and Very Long-term Debentures and Liabilities, Net (cont.)

f. The conditions in the Company's loans agreements that are liable to result in immediate repayment (cont.)

13. In the signed trust deeds in connection with the debentures (Series 19 through Series 22 inclusive) that the Company issued to the public and institutional investors in Israel, it was determined that the trustee will be entitled to require immediate repayment of the entire undischarged balance of the debentures and will be obligated to do so if requested to do so by a special decision that was made in a general meeting of the holders of the debentures, or by the written demand of holders of debentures holding at least 20% of the aggregate par value of the debentures in the Series, on the occurrence of one or more of the events listed below: (1) if the holders of the charges on the Company's assets will realize the charges that they have on the Company's assets, in whole or in part (that is, a cross violation); (2) if a court shall grant a final order or if a valid decision will be made to liquidate the Company (excluding a liquidation for objectives of a merger with another company or a change in the Company's structure). It was determined in the aforesaid trust deed that the end of the validity of the generation and/or generation licenses held by the Company (at the time these Financial Statements were signed) in connection with the debentures (Series 22) does not constitute an immediate repayment event.

14. In some of the loan agreements, the lenders have the right to change the conditions of the loan or to demand immediate repayment, due to a decline in the State's holding percentage in the Company to below 51%.

The Company is of the opinion that it is complying with its liabilities by force of the loans agreements and credit allotted to it and, to the best of its knowledge, at the time these Financial Statements were signed that none of the grounds that provide the lenders with the right to present credit for immediate repayment exists.

g. Government guarantees (for which the balance as of balance sheet date amounts to approximately NIS 7,710 million) have been given to the financial institutions related to certain loans received by the Company.
On February 28, 2006, a State guarantee in the amount of $ 188 million was received in connection with the receipt of a loan from Citibank in respect to the gas project (see Note 13.g above)

Note 19: Income Taxes

a. Benefits provided by the Industry Encouragement Law

The Company is an "Industrial Company" as defined by the Industry Encouragement Law (Taxes)-1969 and, accordingly, is entitled to certain tax benefits, the most significant of which is accelerated depreciation.

b. Taxation under inflationary conditions

The provisions of the Income Tax (Inflationary Adjustments) Law, 1985 apply to the Company. According to the law, the results for tax purposes are measured based on the changes in the Israeli CPI.

c. Tax loss carry-forward to future years

The tax loss available for carry-forward to future years was NIS 15,704 million, at December 31, 2006. The tax loss carry-forward to future is linked to the CPI in accordance with the law mentioned in section b above. The Company recorded a deferred tax asset due to loss carry-forward in the aggregate amount of NIS 3,926 million as of December 31, 2006, and NIS 3,777 million as of December 31, 2005 (section j.1 below), based on management's estimation that it is likely that the loss carry-forward will be utilized (including realization against deferred tax reserves, see section j.2 below).

Note 19: Income Taxes (cont.)

d. Effect of the change in the tax rate

On July 25, 2005, the Knesset (Israeli Parliament) passed the Law for the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2006 - 31%, 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%.

e. Reform in the Israeli tax system:

In 2003, the provisions of the Law for Amendment of the Income Tax Ordinance (No. 132), 2003, became effective ("the reform law") which deal with a comprehensive reform in certain aspects of the Israeli tax system. It is expected that the adoption of the law will result in a gradual decrease in the companies tax liabilities, since a certain portion of the companies' income derives from profits which are subject to capital gains tax. According to the provisions of the reform law, tax at a reduced rate of 25% will apply on capital gains accrued after January 1, 2003, instead of the regular tax rate. In case of the sale of properties purchased before the adoption of the reform law, the reduced tax rate will apply only to the portion of the profit which accrued after the adoption of the law, as computed according to the law. Further, the reform law states that capital losses carried forward for tax purposes may be offset against capital gains for an indefinite period. The reform law also provides for the possibility to offset capital losses from sales of properties outside Israel against capital gains in Israel.

f. The tax that will apply to the shareholders due to the payment of a dividend by the Company is not expected to be material since almost all of the Company's shares are held by the State of Israel.

g. Tax assessments

The Company received final tax assessments through and including the 2003 tax year.

h. Theoretical tax

Below is a reconciliation between the theoretical tax on adjusted income before income taxes (computed as a result of the application of statutory tax rates) and the income taxes included in the statement of income:

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Income before income taxes	332	604	1,095
Statutory tax rate	31%	34%	35%
Computed tax per statutory rate	103	205	384
Expenses disallowed net (including depreciation)	5	9	8
Effect of tax laws related to inflation index	-	4	3
Effect of change in the tax rate	-	(837)	(943)
Effect of the difference between the statutory tax rate and the tax rate according to which the deferred taxes were calculated	(20)	(54)	(55)
	88	**(673)**	**(603)**

Note 19: Income Taxes (cont.)

i. Income taxes, deferred in the statement of income are composed as follows:

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Decrease (increase) in deferred tax assets	(246)	1,631	1,754
Increase (decrease) in deferred tax liabilities	334	(2,331)	(1,738)
Less:			
Effect of transfer of tax benefit related to interest on perpetual debentures to shareholders' equity	-	27	33
Cumulative effect to the beginning of the year of the change in accounting principles, net	-	-	(652)
	88	**(673)**	**(603)**

j. Deferred taxes

1. Deferred tax assets consist of the following:

	Loss carry-forward	**Accrued vacation pay**	**Allowance for doubtful accounts**	**Customer advances, net**	**Accrued pension pay, net**	**Total**
	NIS in millions					
Balance at December 31, 2004	4,352	29	45	1	2,798	7,225
Changes during 2005	(575)	(5)	2	-	(1,053)	(1,631)
Balance at December 31, 2005	3,777	24	47	1	1,745	5,594
Changes during 2006	149	3	1	(1)	94	246
Balance at December 31, 2006[a]	**3,926**	**27**	**48**	**-**	**1,839**	**5,840**
(a) Composed as follows:						
Short-term	-	6	-	-	-	6
Long-term	3,926	21	48	-	1,839	5,834
	3,926	**27**	**48**	**-**	**1,839**	**5,840**

The deferred taxes are calculated according to tax rates of 25% (the tax rates that are expected to apply at the time they are realized).

Note 19: Income Taxes (cont.)

j. Deferred taxes (cont.)

2. Deferred tax liabilities consist of the following:

	Adjustment of depreciable fixed assets, depreciation and other assets	Fuel inventories	Total
		NIS in millions	
Balance at December 31, 2004	12,246	-	12,246
Changes during 2005	(2,333)	2	(2,331)
Balance at December 31, 2005	9,913	2	9,915
Changes during 2006	336	(2)	334
Balance at December 31, 2006[a]	**10,249**	**-**	**10,249**
(a) Composed of:			
Short-term	2	-	2
Long-term	10,247	-	10,247
	10,249	**-**	**10,249**

3. Composition of deferred taxes:

	December 31, 2006	December 31, 2005
	NIS in millions	
Long-term		
Deferred tax liabilities	10,247	9,913
Less: deferred tax assets	(5,834)	(5,588)
Advances in respect of non-deductible expenses	(76)	(64)
	4,337	**4,261**
Short-term		
Deferred tax liabilities	2	2
Less: deferred tax assets	(6)	(6)
	(4)	**(4)**

4. Fixed differences

The balance for the depreciated cost for certain depreciable assets, includes amounts that, due to temporary differences that are related to certain amounts, the liability for deferred taxes due to the adjustment component that will not be allowed for the deduction of these assets will not be recognized, and which is viewed as a fixed difference in accordance with the provisions of Accounting Standard No. 19.
The amounts treated as fixed differences are as follows:

	NIS in millions
The aggregate amount that will not be deductible to the beginning of the year	32
Decrease for the year 2006	(4)
The aggregate nondeductible amount at the end of the year	**28**

Note 19: Income Taxes (cont.)

j. Deferred taxes (cont.)

5. Tax reserves in respect of assets whose depreciation period exceeds 20 years (included in section 3 above), see Note 2.l above)

	NIS in millions
Balance as of December 31, 2005	384
Decrease for the year 2006	(50)
Balance as of December 31, 2006	**334**

Note 20: Perpetual Debentures from the State of Israel

Pursuant to the Company's arrangement with the Treasury, perpetual debentures in a nominal amount of about NIS 15 million (the adjusted amount as of balance sheet date is approximately NIS 2 million) were issued in previous years. The principal in respect of these debentures is unlinked and they bear annual interest at a rate of 5% and 5.75%, fully linked to the known CPI as of balance sheet date. Other than a pledge in a nominal amount, the perpetual debentures are not superior to any other loans extended to the Company. As for the effect of Accounting Standard No. 22 on the manner of presentation of these debentures as of 2006, see Note 2.v above.

Note 21: Commitments, Claims and Contingent Liabilities

a. Commitments

1. **Commitment for the supply of natural gas**
   On July 21, 2005, the Company's Board of Directors approved the agreement that was reached by the Company with EMG for the supply of natural gas according to the agreement. According to the agreement, the amount of gas to be purchased (about 25 billion cubic meters), will be at an average annual pace of 1.7 billion cubic meters over 15 years. The estimated financial scope for the agreement is about $ 2.5 billion for 15 years. The projected date for beginning the flow of the gas is about 24 months after the agreement has been signed. The agreement is for a period of 15 years, with an option for the Company to extend it by five additional years at the same terms and annual amounts. The exercise of the option is conditioned on the advance notice of the Company 36 months prior to the end of the base period.

   On July 31, 2005, the Government approved the above decision of the Board of Directors, in accordance with sections 11(a) and 9 a to the Government Companies Law.

2. **Agreement for the transmission of natural gas with a related party**
   In June 2006, the Company and Natural Gas Lines signed an agreement for the transmission of natural gas, see Note 13f above.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

a. Commitments (cont.)

3. Purchase of natural gas at spot prices
On August 15, 2006, the Company and Tetis Sea Group entered into an agreement to purchase natural gas at spot prices in effect from July 1, 2006 through December 31, 2007. This agreement regulates the cost of the additional gas which the Company will purchase from the Tetis Sea Group for the above period in an amount exceeding the maximum (hourly) quantity stipulated in the basic supply contract signed between the parties.

The purpose of the agreement is to exploit gas quantities that are in excess of the above quantity during peak demands, that the Company needs for the Reading power station and for the power stations at the Hagit and Gezer sites, whose connection to the gas transmission system is expected to be completed in 2007.

According to the agreement, the Company is not obligated to purchase gas and the Tetis Sea Group is not obligated to supply gas under the spot transaction. Prior to signing the agreement, the approval of the Restrictive Trade Practices Commissioner was obtained and the Company will be forced to readdress the Commissioner if it wishes to extend the agreement or deviate from the spot based gas quantities in excess of one billion cubic meters. The spot price is lower than the price of fuel oil and higher than the price of gas under the basic contract. As for the Electricity Authority's decision in this matter, see Note 3.a.7.e above).

4. As of December 31, 2006, the Company has entered into commitments in respect of purchasing equipment and services and construction of facilities, which are not disclosed in the financial statements, as follows:
(a) Ordering, planning, consulting and equipment from suppliers in various currencies expressed in U.S. dollars at their exchange rates as of balance sheet date amounting to approximately $ 211 million and 160 million. These orders will be financed, among others, by existing long-term credit lines from banks and foreign suppliers.
(b) Contracts regarding construction, equipment supply, purchase of fuels and current activities with local suppliers amounting to approximately NIS 3,416 million.

b. Pending claims and contingent liabilities

The Company is involved in pending claims during the ordinary course of its business. The Company is of the opinion, based on the opinion of its legal and professional advisors with respect to these claims, that ultimately, there will not be anything resulting from these claims that will materially affect the financial position as of December 31, 2006 or the results of operations for the year then ended.

Based on the aforesaid opinions, a provision was recorded in the financial statements in the amount of NIS 325 million (as of December 31, 2005 - NIS 294 million) which is adequate to cover the losses that may possibly result from:
(1) Insured claims in respect to which a provision was recorded in the amount of deductible component (a total provision of NIS 51.3 million).
(2) Uninsured claims (that do not include claims in respect to bodily injury) and in respect to which no provision was recorded at all, or for which only a partial provision was recorded (total provision of NIS 242.8 million).
(3) Uninsured claims for bodily injury in respect to which a full provision was recorded (total provision of NIS 21.8 million).
(4) Uninsured claims for bodily injury that, as is customary, are not specified by amounts (total provision of NIS 9.1 million).

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

b. Pending claims and contingent liabilities (cont.)

The total claims pending against the Company in items 1-4 above amount to nearly NIS 11,530 million, of which about NIS 9,309 million is in respect to claims that were requested to be recognized as class actions.

1. **Claims requested to be recognized as class actions**
On March 1, 2006, the Class Actions Law, 2006 ("the Class Actions Law") was enacted by the Knesset, which replaces the sections on class actions in the main legislative articles. The Company, in collaboration with its attorneys, is studying the law that was enacted and its implications, insofar as the aforesaid implications exits, on the claims that are detailed below.
   a. On June 4, 2003, a claim was filed against the Company, to which was attached a request to recognize the claim as a class action, among others, also pursuant to the Restrictive Trade Practices Law, according to the Consumer Protection Law, 1981.
   The claim deals with the collection of interest for the collection of delinquent electricity bills. The amount of the "group" claim was estimated by the claimants to be approximately NIS 150 million.
   The Company is of the opinion, based on the opinion of its attorneys, that the chances to repulse the request for approval as a class action and the claim are reasonable.
   b. A request was filed in the past with the District Court against the Company and the State to approve a claim as a class action. The claim dealt with the collection of the special surcharge to the electricity rate. The claimant claims, inter alia, as detailed in the claim, that the special pension surcharge is a "hidden tax" that is being unlawfully collected, and that the Company must return it, together with interest and linkage, in the amount of approximately NIS 2,847 million in values of the date on which the claim was filed, pursuant to the statement of claim and in the event the claim is recognized as a class action.
   The Company had collected a total of NIS 8,831 million in respect of the special surcharge. The claimant filed a request to amend his claim in light of the legislation of the Class Actions Law. The Company and the State have both submitted their responses to the requested amendment and received the claimant's reply. The Company is of the opinion, based on its legal counsel, that it has good arguments against the requested amendment, including the limitation on a portion of the period of the claim on the grounds of enrichment and an argument whereby the Class Actions Law does not permit, in the case at hand, and since the requested amendment relies upon the Restrictive Trade Practices Law, to file a class action on the grounds of unjust enrichment. However, the request for the amendment relates to the Class Actions Law, which is a relatively new law that has not yet received interpretation, in this context, by the courts and accordingly, the chances of the claim to be accepted cannot be assessed at this stage, in whole or in part. The Company's legal advisors are therefore unable to estimate the impact of said claim on the proceedings discussed above or the Company's chances to prevail during the hearing on the class action.
   c. On May 8, 2006, a request was received at the Company that was filed against the Company for approval as a class action pursuant to the Class Actions Law. The claimant's only claim is that the Company collects arrears interest on the VAT component in a delinquent electric bill and, subsequently, the Company is unlawfully enriched since, he claims, no harm results to the Company from the non-collection of the VAT component until the date on which the VAT is transferred to the tax authorities. The amount for the claim was not estimated by the claimant.
   On October 22, 2006, the Court rejected the request as agreed by the parties. In the context of the hearing, the Court expressed its position, pursuant to which, the Company has the authority to collect arrears interest on the VAT, and that it is even appropriate to do so from an economic perspective.
   d. On May 25, 2006, a request was received at the Company that was filed against the Company for approval as a class action pursuant to the Class Actions Law and the Law for the Prevention of Environmental Hazards (Civil Actions), 1992, which, according to the claimant's estimate, amounts to nearly NIS 200 million.
   The substance of the claim is bodily injuries (asthma) that were caused, he alleges, to the claimant since his childhood as a result of the air pollution that is caused from the smokestacks of the Orot Rabin power station at Hadera. The Company is studying the claim and, in view of the early stage in the examination

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

b. Pending claims and contingent liabilities (cont.)

1. **Claims requested to be recognized as class actions (cont.)**

   of the claimant's factual and legal claims, including everything related to obtaining an opinion from experts, at this stage the Company's attorneys are unable to express an opinion on the chances of success for the claim

   Regarding the Company's compliance with quality of the environment regulations see Note 1g above.

   e. Further to what is stated below in section 9, on June 8, 2006, the Company received a request that was filed against the Company to approve a class action pursuant to the Class Actions Law. The substance of the claim is the damages that were caused, pursuant to what is alleged, as a result of the planned power failures that, according to the claimant's estimate, amount to about NIS 87 million

   Based on the opinion of its attorneys, in light of the flaws in the request for approval, the chances of success for the request for approval in its present format are not great. In addition, the Company has good claims of defense, both in connection with the request to approve the claim as a class action and in connection with the claim in question, at least in respect to the majority of the damages alleged in the context of the claim.

2. **Claims in respect to the pollution of the Kishon river**

   a. In the context of a class action that was filed against "Fertilizers and Chemical Materials Ltd." and "Haifa Chemicals Ltd." for granting an injunction and a mandamus with respect to the pollution of the Kishon river, the above companies filed in 2002 two third party notices against the Company. The claim is not monetary, although the obtaining of a mandamus (for the restoration of the Kishon to its previous condition prior to its being polluted) will have monetary implications. The argument for the attachment of the Company as one of the third parties was that the Haifa power plant contributed to the pollution of the Kishon's water. The Company rejects these claims. In the Company's opinion, based on the opinion of its legal advisors, the claims are still in preliminary stages and, therefore, at this stage it can not be quantified.

   b. In May 2004, in the framework of a claim against Haifa Chemicals Ltd., Oil Refineries Ltd., the Association of Municipalities (Haifa region - Sewage) and the municipality of Haifa that was filed by soldiers of the IDF or their estates (95 claimants as of the date on which the financial statements were signed) in respect to cancer and other diseases caused to them, they alleged, as a result of exposure to the water of the Kishon river, Haifa port, Shemen coast and surrounding waters during their military service, a third party notice was filed against the Company. Similar to the claim stated above in section a, the Company was added as one of the third parties since it is alleged that its power station in Haifa contributed to the pollution of the Kishon's waters.

   The claimants allege that they have contracted cancer and other diseases and some of them, as aforesaid, passed away with the passage of time. Among others, the claimants have attached to their claim a research results report that was prepared by Greenpeace Global, pursuant to which the waters of the Kishon contain high concentrations of heavy metals that are hazardous to health, a environmental standard for the quality of the Kishon's waters that was prepared in February 2000, on which the claimants wish to rely, an a medical opinion that was prepared by Professor Yehud, who defines himself as an academic expert on Oncology, and which determines that there is a high probability of a direct causal - scientific - medical connection between each of the pollutants found in the water of the Kishon river and the outbreak of the diseases contracted by the claimants.

   As stated, the claim was filed against four defendants: one of the claimants, Haifa Chemicals Ltd., sent a third party notice against numerous additional defendants (22 third parties, including the Electric Corporation, Frutarom Ltd., Gadot Petrochemical Industries Ltd., Gadot Biochemical Industries Ltd., Gadot Chemical Containers and Reservoirs Ltd., Fertilizers and Chemical Materials Ltd., Carmel Olefins Ltd. and others), and part of them have sent additional fourth party notices.

   The list is still not final, where each party receiving a notice is entitled to file notices to additional parties on his behalf and, thereby, to expand the circle of defendants. About a third of all of the claimants are legacies and dependents of soldiers who passed away over the years at different ages (part of them passed away

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

b. Pending claims and contingent liabilities (cont.)

2. Claims in respect to the pollution of the Kishon river (cont.)

20-30 years ago) and from different diseases that are alleged to originate from the hazardous materials in the Kishon river's waters. It should be noted that in light of the recent ruling of the Supreme Court in the Ettinger matter, a legacy is eligible for compensation in respect to the loss of earnings for the lost years. There is still not a uniform ruling that implements this law, however, it appears that it is already possible to estimate that the amounts of the compensation for each legacy is liable to increase by tens of millions and perhaps hundreds of millions of shekels, each matter specifically and according to its circumstances.

Since we are dealing with a bodily injury claim, in the framework of which no defined aggregate cash amount was claimed on the date the claim was filed, in respect to the different parameters of which are the basis on which the damage was calculated for each claimant are determined in a clarification procedure of the claim, it is not possible to know at this initial stage what is the damage that was caused to each of them, all the more so what is the relative part of each defendant and third party being sued in this claim.

In order to assess the amounts claimed in this claim (as distinguished from the real damage caused to the claimants as stated above, that can not be estimated at this stage), it is necessary to distinguish between the claims by the legacies and the claims of the living claimants. In respect to legacies, defined amounts are being claimed in the statement of claim amounts to about NIS 128 million in respect to living claimants, the claim includes defined amounts for a special damage components (loss of earnings in the past, third party assistance in the past, and past expenses) that were caused to the claimants and that, together, amount to about NIS 30 million. On the other hand, the general damages components, which are the principal damages when referring to the living victims (future loss of earnings, future third party assistance, and future expenses), are unknown at this stage, and in the evaluation of the Company's attorneys, the amounts being claimed amount to between an additional NIS 250 million and NIS 400 million. The non-monetary damage (pain, suffering, and shortened lifespan) an amount is being claimed in the statement of claim, in spite of it being general damage, in an amount of about NIS 2 million per each claimant, such that the aggregate amount for all of the live claimants in respect to this damage component amounts to about NIS 114 million.

It follows that, in the assessment of the Company's attorneys, the aggregate amount for the claim is in the range of between NIS 650 million and NIS 800 million, including legal fees and court expenses. The Company's attorneys point out in their opinion that the reference is only to a general estimate, based on the assumptions that they assume in the absence of data at this stage, that are liable to turn out to be erroneous when the real data are obtained, in a manner that is liable to significantly change this assessment in respect to the amount of the (such, for example, they assume for the purpose of the estimate of the amount claimed in respect to loss of earnings and future earning capability, that the claimants are among a socio-economic level that is higher than the average, and that they earned double the average wages in the market. In addition, they disregard the various benefits that the claimants are receiving and/or will receive in the future from third parties, such as the National Insurance Institute, the Ministry of Defense, etc., where there is no reference to them in the statement of claim).

It should be pointed out that the reference is to an assessment of the amount of the claim and not to the assessment of the risk of defendants in general and the Company in particular, since at this stage data are unavailable that would enable making such an assessment.

The Company rejects the above claims and, according to the opinion of its attorneys, it believes that the Company's claims present it with a good defense against the claims. As stated above, the claims are in initial stages and in view of their complexity and uniqueness, primarily in everything concerning the types of pollutants that it is alleged that each of the defendants and third parties discharged into the Kishon river's waters and environment, their concentration and the mix created from their being mixed together and, in addition, the variety of diseases of the claimants and the problematic nature in medically determining the causal relationship between each disease and the Kishon river's waters, the Company's attorneys can update their assessment only later on when they will obtain additional data during the clarification of the case.

In the Company's opinion, based on the opinion of its attorneys, data that would enable evaluating the Company's risk are unavailable at this stage.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

b. Pending claims and contingent liabilities (cont.)

3. Claims for payment of municipal taxes from the municipality of Yavne

The municipality of Yavne has made several claims demanding the payment of general property tax for 2000 in an amount aggregating to NIS 32 million in respect to occupied land located, as alleged, under the high voltage and major power lines. The Company disputes these demands. The dispute is, in principle, significant, and very likely it will impact on the manner in which the Company is charged general property tax by the entire local authorities, since the line infrastructure for transmitting electricity is located all across the country. The Company filed a counterclaim against the municipality of Yavne, and a hearing on this claim was scheduled as a preliminary court hearing in the District Court at Tel-Aviv. In addition, the municipality of Yavne sent several additional demands concerning the same matter for the years 2001 and 2002, at an additional scope of approximately NIS 74 million. Subsequent to the Company's application, on September 16, 2003, the Attorney General announced that he would join this procedure. On October 9, 2003, the Company filed a request to consolidate the hearings on this case with those of two additional cases (in the amount of about NIS 179 million), which are also involved in the unlawful charging of electric lines, one by the municipality of Rosh Ha'ayin and the other - by the Givat Shmuel local council. The court ordered the consolidation of the aforesaid cases.

On October 12, 2003, the position of the Attorney General, which supports the position of the Company, was furnished to the Company, according to which the electric lines, land beneath them and around them are exempt from the payment of general property tax. Several hearings have been held and the summations are expected to be finalized in early 2007.

The Company is of the opinion, based on an opinion of its legal advisors and based on the position of the Attorney General, that its claims are grounded from a legal and factual perspective and that its chances for succeeding in the claim are reasonable.

4. Other contingent claims

The Company held discussions with the Israel Lands Authority (which commenced in July 2000) with respect to the lease fees for certain real estate properties at the Reading power plant site which it uses which, at this stage, no request was received for the amount of user's fees in their respect, and the Company is unable to estimate if it will be required to pay user's fees in respect to the past, and in case it is so requested, what the amount will be. (The Company did not pay such user's fees for at least approximately 20 years.) In addition, the Company is unable to estimate the amount which will be determined as lease fees with respect to the future use, and if they will be paid as capitalized lease fees or as current lease fees.

The Company has not recorded any provisions in the financial statements with respect to the claims described above.

5. Other claims for payment of municipal taxes

The Company received demands for property tax for periods prior to the balance sheet date, in amounts exceeding by about NIS 909 million the provision that was recorded for them in the financial statements. These additional demands derived from the changes in classification and the increase in the areas being billed.

In the Company's assessment, ultimately it will not be required to pay these amounts.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

b. Pending claims and contingent liabilities (cont.)

6. The Planning and Building Law

The Planning and Building Law prescribes that the holders of rights in land who were adversely affected by a zoning plan, are entitled to indemnification from the local committees in whose boundaries this zoning plan applies. In order to set up 400 kilovolt lines, zoning plans are required. The Company undertook to indemnify the local committees in whose boundaries these zoning plans apply for the full amounts that the committees will be obliged to pay to the landowners who will be adversely affected, as stated above (aside from one plan, regarding which the indemnification burden shall be divided among the institutional bodies that are involved in the plan).

These undertakings to indemnify were delivered after it was made clear to the Company that not delivering them will result in the non approval of the plans or their suspension.

As of the balance sheet date, claims are pending against several local committees in an amount of about NIS 539 million, in excess of the provisions that were recorded in the Company's financial statements.

In the Company's opinion, based on the opinion of its attorneys, which takes into consideration the opinion of the real estate actuary consulting the Company in regard to the above claims, if all of its arguments shall be rejected and the Company shall be forced to pay cash in respect to these claims, then the Company's exposure in respect to these claims shall not exceed the provision that was recorded in the financial statements. The Company is of the opinion that should any amounts whatsoever will be paid, they will be part of the cost for setting up the relevant transmission lines, and due to the essentialness of the transmission lines, and based on the opinion of its attorneys, if and when the Company shall pay indemnification in respect to the indemnity letters, the Electricity Authority will be obligated to recognize them in the electricity rate.

7. Contingent claims from previous years that were deferred in the reported period

In 2001, a claim was filed against the Company with the regional Labor Court in Tel-Aviv as a collective labor dispute, by the New Histadrut General Labor Federation and the Company's workers committee. The court is being asked in this claim, to declare that the determination of various conditions for entitlement for several conditions of employment and/or retirement in relation to male and female employees constitute discrimination which is forbidden by the Equal Wages Law for Male and Female Employees, 1996.

On May 18, 2006, the regional Labor Court in Tel-Aviv rejected the claim.

8. Contingent Assets

In January 2005, there was a failure at one of the generation units at the Eshkol power station which is operated by natural gas. The repair of the failure was completed in June 2005, and during this period the Company used alternative fuels that resulted in an increase in fuel expenses in the amount of about $ 24 million. According to the Company's insurance policy that covers the Company for cases such as these, the Company filed a claim with the insurance company in an amount of about $ 22 million, which constitutes the cost to the Company in excess of its deductible. The Company did not record a provision for income receivable in respect to this insurance claim.

9. Contingent liabilities

On June 4 and 5, 2006, there were several power failures that were initiated for defined periods of time in various regions of the country as a result of the demand for electricity that exceeded the available capacity of electricity generation. In the Company's assessment, it is possible that due to those same reasons similar events will occur in the future. At this stage, the Company is unable to assess the future implications of these events on its financial position.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

c. Labor disputes

1. In the past, the Company's workers committee gave notice of several labor disputes and strikes, in accordance with the Law for Labor Disputes and Strikes, 1957. The grounds for the labor disputes concern the wage agreements and the employees' job security as a result of the intention to carry out structural changes in the electricity sector. The sanctions imposed by the employees as of the date on which these Financial Statements were signed are:

a. There is no cooperation with the requests by the Company's management, according to which it is necessary to get organized for preparing separate financial statements for each activity, as required by the directives of the Companies Authority.

b. Sanctions in the framework of the ERP project, which is an organizational management system that is intended to support the management of all of the Company's internal resources, and in this framework the prohibition for the Company's employees to operate the system.

Regarding the implications of the sanctions for the Company, the Company has applied to the Labor Court in order to obtain reliefs in respect to the imposition of sanctions.
The Company and the workers committee reached an agreement that all of the procedures that are being pursued in the labor court will be halted and that any judgment that was handed down regarding the matter will not constitute an estoppel by judgment and that all of the parties reserve their rights and claims. The Company gave notice that in order to obtain a legal decision on the issues under proceedings that were pursued or any other events whatsoever it will apply a new request to the regional labor court.
On February 15, 2006, a labor dispute was announced, and on July 5, 2006 notification was made of a strike by force of the Labor Dispute Settlement Act.

The matters under dispute were defined as follows:

a. Structural changes at the Company that are being carried out through the reduction in the Company's activities, in a manner that presents the employees' representatives with a fait accompli concerning those changes.

b. Although the structural changes have ramifications on the employees from all aspects, including but not exclusively working conditions, rights, status, occupational security, pension rights and the status of the employees organization, and despite the fact that the negotiations between the parties has not been exhausted, unilateral steps are being employed to implement the changes.

c. The demand of the representative employees organization to conduct negotiations and to sign a legally ratified collective agreement that will ensure the safeguarding of the employees and their rights.

Subsequent to the Government's decision dated September 12, 2006 regarding the Company's structural change, commencing September 14, 2006, the employees took sanctions, the principal elements of which are: breaking contact with the management, with outside parties (the ministries of National Infrastructures and Finance and the Electricity Authority) and with the Board of Directors, non-cooperation with the administration of the change, breaking contact with outside consultants, breaking contact with the attorneys, non-issuance of bills to consumers, not cutting off of service to delinquent consumers, removal of contractors, non issuance of payments to suppliers, not repairing failures at the power stations, not carrying out overhauls at the generation units, not unloading coal, delay in carrying out projects.
The Company applied a request with the regional labor court for an injunction against the sanctions.

On September 27, 2006, the parties informed the labor court that they had reached the following agreements:

a. There will be intensive discussions between the team that is composed of representatives of the State, the Company, the employees organization and the Histadrut until December 7, 2006 regarding the change in the structure of electricity sector, as well as regarding the rights of the employees and the pensioners in the framework of the structural change.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

c. Labor disputes (cont.)

On September 27, 2006, the parties informed the labor court that they had reached the following agreements: (cont.)

If required, following the above date, the period will be extended until January 7, 2007 while upgrading the rank of the representatives of the parties.

b. During the entire aforementioned period, the State will not initiate an amendment to the Arrangements Laws 2007 involving the structural change.

c. The employees will immediately return to their work routine as it existed on September 13, 2006, and during the entire aforesaid period they will not take sanctions regarding the issues involved in the change in structure, insofar as unilateral steps to implement are not taken.

In light of the above agreements, the legal proceedings were halted. The Company is unable to assess the damages resulting from the above sanctions.

As a result of the instruction of the supervisor of wages on October 3, 2006, to immediately cease the various payments to senior employees and pensioners, in respect of whom the supervisor determined that they exceed what is permitted pursuant to the Budget Foundations Law, the employees organization issued an order forbidding the employees to carry out the supervisor's directive.

On October 19, 2006, the Company filed a request for an injunction against the employees' sanctions. On that same date, a decision was reached, pursuant to which it was determined as follows:

a. An order was granted that prevents sanctions that prohibit the receipt of wages by employees and pensioners.

b. Until there is a final decision on the request, the supervisor's decision will not be carried out.

On November 12, 2006, a ruling was made pursuant to the agreements between the parties, according to which the strike is ended, the supervisor of wages decision from October 3, 2006 will be implemented and the proceeding will be stricker. Over the course of a month, the parties will negotiate, the purpose of which is to reach an agreement that will make continued legal proceedings between the parties regarding the supervisor's decisions of August 21, 2006 and October 3, 2006 superfluous. Until the negotiations are exhausted, the Company will not need to act to implement the supervisor's decision regarding the filing of claims for refunds. During the period of the negotiations, neither of the parties will take unilateral steps. Should the negotiation procedure end, no party whatsoever will take unilateral steps except following seven days from the end of the negotiations. There is nothing in the agreement by the parties in order to prevent any of the individual employees or pensioners of the Company or their survivors from taking individual or group proceedings against the supervisor's decisions. The claim was struck without an order for expenses.

Subsequent to the decision of the Board of Directors dated September 7, 2006 regarding the freeze in the hiring of employees, the granting of definitions and granting tenure, on November 1, 2006, the employees in the Northern region began taking sanctions, the principal element of which is the preventing of entry to contractors, primarily security and guard contractors, as well as contractors in the information and communications systems department and contractors for the purpose of working or carrying out examinations at Alon Tavor.

On that same date, the Company filed a request for an injunction against the sanctions. On the following day, a decision was issued instructing the employees to avoid any action that would interfere with the providing of orderly security services.

At this stage, all of the sanctions were halted.

On February 18, 2007, the employees initiated sanctions as follows:

1. No information is to be delivered to the Company's Board of Directors.
2. No information is to be delivered to the different Government offices.
3. No more disconnecting delinquent consumers from the electricity network.
4. The coal feeding work in the Med power station will only be done during regular work hours.
5. No hearings for the dismissal of employees who have not yet been employed with the Company ten years (and cannot be dismissed in any case) will be held.
6. Halting the training courses for call center operators.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

c. Labor disputes (cont.)

The grounds for the sanctions, according to the workers union: unilateral steps taken by the Company's management as directed by the Board of Directors, including a temporary provision regarding tenure, an attempted restructuring of the Company, freezing employee definitions, halting the incorporation of new employees and others.

On February 22, 2007, the Company appealed to the Haifa regional labor court requesting to grant it a temporary injunction against the sanctions (hereinafter: the tenure dispute).

On February 20, 2007, the employees' national secretariat announced a general strike under which all the employees were asked to abandon their work stations effective February 20, 2007 at 2:30 pm until further notice. All the shifts, including the shifts at the power stations will not be changed.

On the same date, the Company filed an urgent motion with the Haifa regional labor court requesting to issue temporary injunctions against the strike, ex parte ("the restructuring dispute"). On that evening, an ex parte injunction was awarded whereby the employees will refrain from committing any act, deed or sanction that will or is liable to disrupt the power supply in the State of Israel; they are also to refrain from committing any acts that will or are liable to lead to the disruption of the power in the State of Israel. The employees returned to regular work immediately upon receiving the injunction.

In a hearing held on February 21, 2007 and attended by both parties, a temporary injunction was awarded forbidding the employees from disrupting in any way, whether in actions or in sanctions, directly or indirectly, the power supply to the State. The injunction will remain in effect until it is cancelled by an authorized legal jurisdiction.

On February 26, 2007, the Histadrut and workers committee filed an appeal to the decision of the regional court of February 21, 2007 with the National Labor Court.

On March 8, 2007, a hearing was held at the Haifa regional labor court regarding both the tenure dispute and the restructuring dispute.

As for the tenure dispute, the employees announced that they were not taking sanctions on the grounds of unilateral decisions made by the Company in the matter of granting tenure and the Company's motions in that respect are therefore stricken.

On March 18, 2007, a verdict was rendered by the National Labor Court in connection with the restructuring dispute, stipulating the following:

a. The State, the Company and the Histadrut are willing to enter into negotiations regarding the implications of the restructuring on employee rights and work conditions.
b. Until March 29, 2007, the State's and the Company's authorized representatives will produce their initial proposal for negotiations to the Chairman of the Histadrut.
c. Until March 29, 2007, the Government will grant its decision specifying the authorized entities on behalf of the State for conducting and finalizing the negotiations. As far as these entities are the Ministers, they will notify the other parties of their authorized representatives for conducting the negotiations.
d. Within two weeks from obtaining the State's proposal, a meeting for negotiations will be held between the parties and two weeks later, the Histadrut's representatives will present their proposal for the negotiations. Two weeks after that date, another meeting will be held followed by continued intensive negotiations between the parties.
e. At this stage, the employees are not obligated to cooperate in providing the required data unless they find it appropriate for advancing the negotiations.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

c. Labor disputes (cont.)

On March 18, 2007, a verdict was rendered by the National Labor Court in connection with the restructuring dispute, stipulating the following: (cont.)

f. The employees will continue to cooperate in all matters pertaining to developing the ERP, DMS and EMS systems but they are not obligated to operate them.
g. Pursuant to above, no structural measures that disrupt the Company's operations will be taken.
h. The pending proceedings in the regional labor court and in the National Labor Court regarding the restructuring have bee stricken.

On March 11, 2007, the coordinating and executing committee at the Histadrut approved the labor dispute of July 2006 and at that, this dispute is valid and stands even in the post-legislative situation.

On March 13, 2007, a notification of strike or a shutdown according to the Law for the Settlement of Labor Disputes was delivered.

The matters pertaining to the dispute are as follows:

a. A dead-end in the negotiations for signing a salary agreement for the period from January 1, 2006.
b. The Company's attempts to invalidate the collective work relations due to its intention to transfer the employees employed under the collective labor agreement to personal contracts while infringing on the right of association and the collective agreement's status.
c. An exceptional work load imposed on the employees as a result of the Company's refusal to fill vacant posts.
d. A unilateral freeze of personal definitions of employees by the Company.
e. The employer's unilateral decision not to grant tenure.
f. Red tape exercised by the Company's management with respect to the organization's demand for changing the status of the employees of the national security department center from contractor employees to Company employees.
g. The organization's demand for rewarding the tractor employees at the Orot Rabin power station with the unique compensation granted to shift employees.
h. The employer has acted in mala fide and outside the acceptable work relations while harming the status of the workers committee by making unilateral decisions regarding work conditions.
i. With respect to all the grounds stipulated in b through h above, the employer refuses to conduct collective negotiations and disregards the organization's demands to settle the disputes through a collective agreement.

The strike was scheduled for March 28, 2007 and onwards.

Management of the Company believes that even in the event that these labor disputes are not resolved and strikes will commence, the Company's financial position will not be adversely affected. Until the date of signing the financial statements, no strikes were initiated arising from these labor disputes. As for the matter of the restructuring, see section 1.a above.

Note 21: Commitments, Claims and Contingent Liabilities (cont.)

c. Labor disputes (cont.)

2. Sanctions by the engineers, practical engineers and technicians in the planning and engineering department:
On August 14, 2005, the union of engineers, architects and academics in the technological professions in Israel, gave notice of a labor dispute and notice of a strike that shall commence on September 4, 2005.

The matters under dispute according to the notice are:

- An attempt to harm the engineers public by not including the engineers union in the discussions concerning matters that are related to that public.
- The deliberate and in bad faith impairment of the scope of work required from the engineers.
- That a wage agreement for 2000 and thereafter has not been reached with the engineers.
- An attempt to prevent the engineers from receiving relief, consultation and treatment from the engineers union, through the prevention of the physical conditions that are required.
- Discrimination of the engineers by acting differently toward the engineers union than in relation to other unions.
- All of the grounds in the notice of a labor dispute dated January 30, 2005 that was delivered by the New General Workers Union (Histadrut), all of which is in respect to the engineers.

On September 6, 2005, the engineers and technicians union in the New General Workers Union (Histadrut) gave notice of a strike as of September 21, 2005.

The issues involved in the dispute are:

- A demand by the representatives of the employees for businesslike negotiations and in good faith with the engineers union and with the professional union that represents them concerning the anticipation dismissals of tens of technicians and engineers in the planning division.
- The lack of an agreement for the transfer of employees from the rank of management to the rank of engineers and technicians.
- The disregarding of the engineers union in the holding of negotiations in everything concerning the employees in that sector.

The Company claims that the reference is to illegal sanctions. Among the actions that were taken in the context of the sanctions: not carrying out top-level controls; disruptions in delivering engineering planning plans to the division for carrying out projects; non participation in meetings; shutdown of the computer systems in the engineering planning division.
Subsequent to the sanctions, on September 21, 2005, the Company notified the supervisor of labor relations at the Ministry of Industry, Trade and Labor of a protective shutdown of the civilian segment, the mechanical segment, the electric segment and the sub-stations in the Company's engineering planning division.

The engineers' sanctions are still in effect and are manifested by occasional disruptions of the work.

The protective shutdown has not been activated.

Management of the Company believes that even in the event that these labor disputes are not resolved and strikes will commence, the Company's financial position will not be adversely affected. Until the date of signing the financial statements, no strikes were initiated arising from these labor disputes. The dispute and strike announcements are still valid.

Note 22: Capital Reserves

	December 31, 2006	December 31, 2005
	NIS in millions	
Capital reserve according to Securities Regulations - transactions with controlling interests: In respect to the sale of land to the Ports and Railway Authority	59	59
In respect to the purchase of National Coal (see Note 13a)	(2)	(2)
Company's assets renewal reserve(1)	697	697
Capital redemption reserve fund	43	43
Premium on shares	24	24
Reserves from realization of assets	30	30
	851	**851**

(1) The assets renewal reserve represents profits in excess of amounts permitted for payment of dividends under the Concession for 1985 and 1986, which has been designated by the Minister of Energy for the renewal of assets.

The Company has established various reserves pursuant to applicable laws or at the discretion of the Minister responsible for the Company at the time of their establishment. Such reserves, other than the reserves from realization of assets, cannot be distributed as dividends.

Note 23: Financial Instruments and Linkage Terms for Balance Sheet Balances

a. Financial instruments - General

1. **Exchange rate risk**
The Company's activities expose it to various financial risks such as market risk (including foreign currency risk, fair value risk in respect of interest rate and price risk), credit risk, liquidity risk and cash flow risk in respect of interest rate. The Company's comprehensive risk management plan focuses on activities that reduce to a minimum any possible adverse effects on the Company's financial performances. The Company utilizes derivatives in order to hedge itself against certain exposures to risks. In order to minimize the Company's exposure to foreign currency fluctuations, the Board of Directors has resolved the following:
   a. The amount of real exposure in respect of linked liabilities denominated in foreign currency that have been assigned to the electricity consumers, the Company will enter into foreign currency hedging transactions (mainly swap and forward transactions) in order to adjust the structure of expenses to the recognized structure of revenues (the Bank of Israel's composition of the Basket of Currencies). The swap transactions will be undertaken for a period of at least two years while taking into consideration the interest rate gaps between the different currencies with an allowed exposure of up to 15% of the balance of loans in the same currency.
   b. As for the Company's over-exposure in respect of its liabilities in foreign currency (after the adoption of section a above), the Company will swap its foreign currency liabilities for index-linked liabilities by carrying out foreign currency-CPI hedging transactions (mainly swap and forward transactions) and, should the market conditions justify it, foreign currency-NIS transaction in order to reduce its exposure to foreign currency risks.
   The swap transactions will be performed for a period of at least two years while taking into consideration the inflation rates in Israel and the Western countries and the interest rates in the capital markets.
   As a rule, transactions will be entered into to cover at least 85% of the remaining exposure so that the exposure amount for each currency will not exceed a cumulative 15% of the balance of loans in same currency.

Note 23: Financial Instruments and Linkage Terms for Balance Sheet Balances (cont.)

a. Financial instruments - General (cont.)

1. **Exchange rate risk (cont.)**
   c. In order to allow a dynamic Implementation of the policy discussed in section b above, and in order to avoid technical random irregularities, the vice president of finances and economics instructed that the amount of exposure for each currency, both in respect of the hedged amount and the balance of the exposure, will not be above or below 5% of the outstanding loan balance in same currency with the addition of 2% of the remaining loans for each 1% interest gap, even if it is negative, that is to the Company's debit.
   d. An irregularity in excess of 15% will be allowed if the amount of the irregularity does not exceed $ 10 million or an equivalent sum in another foreign currency, each currency taken separately.
   e. Other transactions such as options and irs transactions in currencies and interest rates will be signed if market conditions indicate profitability/risk reduction.

   The Company has entered into swap transactions of currencies that are designed to partially reduce the Company's exposure resulting from the difference between the actual level of liabilities and the structure of the electricity rate (see b below and Note 2.r above). The Company also carries out foreign currency forward transactions for periods of up to 12 months (see Note 18.a above).

2. **Credit risks**
   The Company's cash and cash equivalents are deposited with banking institutions and accordingly, the Company does not anticipate any credit losses in their respect.

   The exposure to credit risks in respect of customers is limited given the large number of the Company's customers and the fact that the Company supplies an essential ongoing service. The Company included allowances for doubtful accounts, which management believes are adequate to cover such risks.

3. **Interest rate risks**
   The Group's interest rate risk is mainly derived from long-term loans. Loans bearing variable interest rates expose the Group to interest rate risk in respect of cash flow. Loans bearing fixed interest rates expose the Group to interest rate risk in respect of fair value.
   a. The Company has an interest mix (fixed/variable) dependent on the status of liabilities. The Company has entered into interest swap hedging transactions for swapping fixed interest with variable interest and it is reviewing the interest trends in capital markets to decide on the timing and scope of these transactions.
   b. <u>Cash flow risk in respect of variable interest rate</u>
   The variable interest risks (other than the changes in exchange rates discussed above) are immaterial to the Company's cash flows. The Company has entered into several interest swap transactions. In the context of these transactions, the Company has swapped a portion of the interest rate determined for certain of its liabilities for a variable interest rate and a portion of the variable interest rate on certain of its liabilities for a fixed interest rate.

   As of December 31, 2006, the Company has no open interest swap commitments.

4. **Liquidity risk**
   The Company aims to raise long-term financial resources in capital markets in order to be able to finance the development plans for the electricity sector while maintaining a current cash reserve and credit balances within single borrower limitations in the Israeli bank system.

   Transactions with financial instruments are carried out with banking institutions and the Company does not anticipate any losses resulting from credit risks in their respect. The Company does not hold or sell financial instruments for commercial purposes.

Note 23: Financial Instruments and Linkage Terms for Balance Sheet Balances (cont.)

b. The following are details of the open commitments for carrying out foreign currency swap transactions and forward transactions designed to reduce the exposure resulting from the differences between the linkage terms of the commitments and the structure of the electricity rate as of December 31, 2006

	Swap Transactions(1)	**Forward Transactions(2)**
	NIS in millions	
Purchase of:		
U.S. Dollars	8,718	3,138
Euro	927	1,136
Japanese Yen	-	1,766
Sterling Pound	459	167
Swiss Francs	97	-
New Israeli Shekels ("NIS")	-	1,361
	10,201	**7,568**
In exchange for:		
Linked NIS	3,926	-
NIS	4,126	4,939
Euro	1,615	112
Sterling Pound	1,369	-
U.S. Dollars	254	2,616
	11,290	**7,667**

(1) The majority of swap transactions are for a period of up to 10 years.
(2) The majority of forward transactions are for a period of up to 12 months.

The fair value and book value of the above transactions as of December 31, 2006 are liabilities of about NIS 1,292 million and about NIS 1,188 million, respectively. The loss from the financial instruments in this item amounts to NIS 1,211 million in 2006 and the losses from the financial instruments amount to NIS 478 million and NIS 623 million in 2005 and 2004, respectively.

c. Fair value of financial instruments

	Book Value		**Fair Value**
	December 31,		**December 31,**
	2006	**2005**	**2006**
	NIS in millions		
Financial assets			
Investments in debentures(1)	838	649	838
Financial liabilities			
Long-term loans at fixed interest(2)	8,710	8,760	9,405
Other loans at variable interest(3)	6,350	5,873	6,350
Marketable debentures(1)	6,870	7,048	7,287
Non-marketable debentures(2)	19,585	18,882	20,878
	41,515	**40,563**	**43,920**

(1) The fair value is based on quoted market prices in an active market as of balance sheet date.
(2) The fair value is based on fair interest rates at balance sheet dates (the fair value of a long-term loan received, bearing fixed interest is based on the calculation of the current value of cash flows at an interest rate as accepted for a loan of similar characteristics).
(3) The book value approximates fair value.

The carrying amount of cash and cash equivalents, short-term investments, receivables, other current assets, payables and accrued expenses approximates their fair value.

Note 23: Financial Instruments and Linkage Terms for Balance Sheet Balances (cont.)

d. Linkage terms for balance sheet balances

	December 31, 2005							
	Linked to The U.S. Dollar	Linked to the Euro	Linked to Japanese Yen	Linked to other foreign currencies	Linked to the CPI	Unlinked	Non-monetary	Total
	NIS in millions							
Assets:								
Cash and cash equivalents	-	-	-	-	-	1,220	-	1,220
Short-term investments	-	-	-	-	-	403	-	403
Trade receivables for sales of electricity	-	-	-	-	-	2,843	-	2,843
Other accounts receivable - unbilled	1,431	29	-	-	(189)	(335)	38	974*
Long-term receivables (not including current maturities)	5,082	-	-	-	(1,101)	(1,841)	1	2,142
Long-term deposits	-	-	-	-	649	-	-	649
Total	**6,513**	**29**	**-**	**-**	**(641)**	**2,290**	**39**	**8,230**
Liabilities:								
Short-term credit from banks and other credit suppliers	2,676	615	(1,482)	75	1,613	19	-	3,516
Liabilities to suppliers and service suppliers	263	170	-	14	-	1,088	-	1,535
Accounts payable and credit balances	293	46	27	1	366	1,153	-	1,886*
Liabilities incurred through employee-employer relations	-	-	-	-	-	671	-	671
Deferred taxes, net	-	-	-	-	-	(64)	4,325	4,261
Long-term liabilities (not including current maturities)(1)	15,150	6,316	3,322	1,127	13,228	1,851	-	40,994
Total	**18,382**	**7,147**	**1,867**	**1,217**	**15,207**	**4,718**	**4,325**	**52,863**
Net Total	**(11,869)**	**(7,118)**	**(1,867)**	**(1,217)**	**(15,848)**	**(2,428)**	**(4,286)**	**(44,633)**

* Reclassified.

(1) a. A portion of the costs in respect of the exposure in or linked to foreign currency is covered by the current electricity rate.
b. A portion of the costs in respect of long-term liabilities is capitalized to fixed assets under construction (see Note 28).

Note 23: Financial Instruments and Linkage Terms for Balance Sheet Balances (cont.)

d. Linkage terms for balance sheet balances

	December 31, 2005								
	Linked to The U.S. Dollar	**Linked to the Euro**	**Linked to Japanese Yen**	**Linked to other foreign currencies**	**Linked to the CPI**	**Unlinked**	**Total**	**Non-monetary**	**Total**
	NIS in millions								
Assets:									
Cash and cash equivalents	-	-	-	-	-	721	721	-	721
Short-term investments	-	-	-	-	-	211	211	-	211
Trade receivables for sales of electricity	-	-	-	-	-	2,871	2,871	-	2,871
Other accounts receivable - unbilled	491	-	-	-	1	154	646	32	678
Long-term receivables	893	(262)	-	(129)	130	1,798	2,430	3	2,433
Long-term deposits	-	-	-	-	-	838	838	-	838
Total	**1,384**	**(262)**	**-**	**(129)**	**131**	**6,593**	**7,717**	**35**	**7,752**
Liabilities:									
Short-term credit from banks and other credit suppliers	(2,377)	(334)	(1,767)	(453)	3,963	3,824	2,856	(55)	2,801
Liabilities to suppliers and service suppliers	189	99	-	1	-	1,191	1,480	-	1,480
Accounts payable and credit balances	260	56	24	537	265	1,355	2,497	-	2,497
Liabilities incurred through employee-employer relations	-	-	-	-	-	712	712	-	712
Deferred taxes, net	-	-	-	-	-	(76)	(76)	4,413	4,337
Long-term liabilities(1)	12,178	5,093	3,013	1,231	15,690	3,004	40,209	(291)	39,918
Perpetual debentures	-	-	-	-	2,098	-	2,098	-	2,098
Total	10,250	4,914	1,270	1,316	22,016	10,010	49,776	4,067	53,843
Net Total	(8,866)	(5,176)	(1,270)	(1,445)	(21,885)	(3,417)	(42,059)		
Total average balance sheet balances, net(2)	**(10,815)**	**(6,277)**	**(1,536)**	**(1,196)**	**(20,459)**	**(1,745)**			

(1) a. A portion of the costs in respect of the exposure in or linked to foreign currency is covered by the current electricity rate.
b. A portion of the costs in respect of long-term liabilities is capitalized to fixed assets under construction (see Note 28).
(2) The average balance sheet balance is calculated based on quarter frequency during the reported year.

Note 24: Revenues

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Residential	6,223	6,315	5,846
Commercial	6,755	6,745	5,958
Agriculture	638	649	597
Industrial	3,586	3,722	3,277
Water pumping	843	870	826
Revenues from the sale of electricity, gross	**18,045**	**18,301**	**16,504**
Less:			
Collection of pension component	-	(959)	(1,080)
Collection and provision in respect of regulatory assets	(562)	(672)	(591)
Revenues from the sale of electricity, net	**17,483**	**16,670**	**14,833**
Other income	107	78	92
	17,590	**16,748**	**14,925**

Note 25: Sales and Marketing Expenses

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Wages	501	469	435
Consumer services	139	141*	136*
Depreciation	123	110	104
	763	**720**	**675**

* Reclassified.

Note 26: Administrative and General Expenses

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Wages	384	329	312
Allowance for doubtful accounts	46	74	42
Allowance for Gas Project	55	-	-
Depreciation and amortization	132	104	95
Others	149	131*	172*
	766	**638**	**621**

* Reclassified.

Note 27: Wage Costs

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Total wage cost *	4,073	3,791	3,611
Less - wages charged to work at others' expense	115	86	71
Less - wages charged for constructing fixed assets	1,552	1,575	1,505
	1,667	1,661	1,576
Wage costs included in the statement of income items, net	**2,406**	**2,130**	**2,035**
* Includes a provision for a bonus in the amount of	**30**	**55**	**31**

On February 2, 2006, a wage agreement was signed for 2000 through 2005. In the past, provisions were recorded in respect to this agreement in the financial statements, and in the reported year the Company increased the wage costs in respect thereto, in the amount of about NIS 11 million and an additional NIS 21 million (based on management's estimate) in respect of a wage agreement to be signed in the future in respect of 2006.

Note 28: Financial Expenses (Income), Net

a. Financial expenses (income), Net

	Year Ended December 31, 2006		
	Other financial expenses	**Erosion of liabilities**	**Total**
	NIS in millions		
Financial expenses (income) in respect to:			
Debentures(1)	1,843	(1,486)	357
Loans(2)	849	(423)	426
Swap transactions	14	1,211	1,225
Income from marketable securities	(54)	(32)	(86)
Others, net	(185)	(33)	(218)
	2,467	(763)	1,704
Capitalization of financial expenses(3)	(381)	207	(174)
Transfer of financial expenses (income) to a regulatory asset	-	646	646
Financial expenses (income), net	**2,086**	**90**	**2,176**

(1) Other financial expenses (income) for debentures include amortization of the issuance and related costs, discounts and premiums of debentures in 2006, 2005 and 2004 totaling NIS (64) million, NIS (32) million and NIS 6 million, respectively.
(2) Financial expenses for loans include amortization of the capital raising costs of NIS 45 million, NIS 47 million and NIS 43 million in 2006, 2005 and 2004, respectively.
(3) a. The capitalization rate in respect of the unspecific liabilities during December 31, 2006 is 1.6129%.
b. The capitalization rate in respect of the unspecific liabilities during December 31, 2005 is 6.7646%.
c. The capitalization rate in respect of the unspecific liabilities during December 31, 2004 is 4.9263%.

Note 28: Financial Expenses (Income), Net (cont.)

a. Financial expenses (income), Net (cont.)

Year Ended December 31, 2005			Year Ended December 31, 2004		
Other financial expenses	**Erosion of liabilities**	**Total**	**Other financial expenses**	**Erosion of liabilities**	**Total**
NIS in millions			NIS in millions		
1,738	354	2,092	1,644	(392)	1,252
881	(273)	608	940	99	1,039
(6)	(477)	(483)	-	283	283
(2)	-	(2)	-	-	-
(201)	49	(152)	(182)	20	(162)
2,410	(347)	2,063	2,402	10	2,412
(409)	171	(238)	(337)	(96)	(433)
-	88	88	-	2	2
2,001	**(88)**	**1,913**	**2,065**	**(84)**	**1,981**

Note 28: Financial Expenses (Income), Net (cont.)

b. Loss (gain) from the erosion of liabilities, net:

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Loss (gain) resulting from the change in CPI in respect of	-	16	(1)
Loss (gain) resulting from differences in the change in the known CPI as compared to the change in the CPI for the balance sheet dates	(34)	32	(33)
Loss from real devaluation (gain from real revaluation) of foreign currency, net[(1)]	(696)	(444)	24
Others	(33)	49	20
	(763)	(347)	10

(1) Net after effect of swap transactions and after the offset of the erosion of deposits of the proceeds from private raisings of capital and other loans deposited in banks.

Note 29: Other Expenses (Income), Net

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Capital losses	1	40	21
Provision for wage agreement	-	-	66
Provisions for regulatory assets (see Note 3 above)	(2)	(18)	15
Other income, net	(6)	(14)	(2)
Total of other expenses (income), net	**(7)**	**8**	**100**

Note 30: Nominal Financial Statements

a. Condensed balance sheets

	Note	**December 31, 2006**	**December 31, 2005**
		NIS in millions	
Current assets		6,952	8,079*
Long-term receivables		1,946	2,142
Investments in investee companies (excess of losses over investments in investees)		55	51
Fixed assets, net		42,487	41,383
Other assets		-	364
		51,440	**52,019**
Current liabilities		6,371	7,272*
Long-term and very long-term liabilities, net		41,878	42,555
Perpetual debentures		2,098	15
Shareholders' equity	30c	1,093	2,177
		51,440	**52,019**

* Reclassified.

Note 30: Nominal Financial Statements (cont.)

b. Condensed statements of income

	Year Ended December 31,		
	2006	**2005**	**2004**
	NIS in millions		
Revenues	17,745	16,549	14,615
Cost of operating the electricity system	12,392	11,538*	8,228
Profits from operating the electricity system	5,353	5,011	6,387
Sales and marketing expenses	746	696*	1,482
Administrative and general expenses	752	627*	596
Expenses from liabilities to pensioners, net	139	99	89
	1,637	**1,422**	**2,167**
Income from current operations	3,716	3,589	4,220
Financial expenses, net	2,357	3,110	2,899
Other expenses (income), net	(12)	(6)	146
Income from current operations before income taxes	1,371	485	1,175
Income taxes: deferred	380	176	579
Income from current operations after income taxes	991	309	596
Equity in the earnings of affiliated company, net	9	8	4
Income before special items	1,000	317	600
Cumulative effect to the beginning of the year due to change in accounting principles, net	-	-	1,126
Net income	**1,000**	**317**	**1,726**

* Reclassified.

Note 30: Nominal Financial Statements (cont.)

c. Statements of changes in shareholders' equity

	Paid-up Share Capital	Capital Reserves	Dividend Provided	Retained Earnings (Accumulated Deficit)	Total
			NIS in millions		
Balance at January 1, 2004	**12**	**195**	**106**	**(73)**	**240**
Changes during 2004					
Net income	-	-	-	1,726	1,726
Dividend payable for 2003	-	-	(106)	-	(106)
Dividend provided for 2004	-	-	1,461	(1,461)	-
Balance at December 31, 2004	**12**	**195**	**1,461**	**192**	**1,860**
Changes during 2005					
Net income	-	-	-	317	317
Dividend provided for 2005	-	-	736	(736)	-
Balance at December 31, 2005	**12**	**195**	**2,197**	**(227)**	**2,177**
Changes during 2006					
Reclassification of perpetual debentures (see Note 2.c.3)	-	(2,084)	-	-	(2,084)
Net income	-	-	-	1,000	1,000
Dividend provided for 2006	-	-	160	(160)	-
Balance at December 31, 2006	**12**	**(1,889)**	**2,357**	**613**	**1,093**

Note 31: Information in Nominal Values

a. Share capital

Composed as follows:

	December 31, 2006		December 31, 2005
	Authorized	**Issued and Paid-up**	**Issued and Paid-up**
		NIS in millions	
80,167,387 Ordinary shares of NIS 0.1 par value each (issued and paid-up - 80,164,986 Ordinary shares)	8,017	8,017	8,017
40,053,252 Ordinary "B" shares of NIS 0.1 par value each	4,005	4,005	4,005
39,531 unclassified shares of NIS 0.1 par value each	4	-	-
Total	**12,026**	**12,022**	**12,022**

Note 31: Information in Nominal Values (cont.)

b. Shareholders' rights

1. **Upon distribution of dividends:**

The first five percent to the Ordinary shareholders	-	Ordinary shareholders only.
The next five percent to the Ordinary shareholders	-	Ordinary and Ordinary "B" shareholders - equal percentages, until the cumulative sum of dividends paid to Ordinary shareholders reaches 10% and Ordinary "B" shareholders reaches 5% annually.
The next five percent to the Ordinary shareholders	-	Ordinary "B" shareholders - twice the percentage of Ordinary shareholders, until the cumulative sum of dividends paid to Ordinary shareholders reaches 15% and ordinary "B" shareholders reaches 15% annually.
Thereafter, the following percentages	-	Ordinary and Ordinary "B" shareholders - equal percentages.

In the Company's opinion, shareholders' dividend rights relate to the par value of the adjusted share capital.

2. **Upon liquidation:**
The surplus after refund of paid-up share capital to shareholders, first to Ordinary shareholders and then to Ordinary "B" shareholders, to be allocated among shareholders on a proportional basis to the paid-up capital at the beginning of the liquidation of shares held by each of them.

3. On the date of the financial statements, the State of Israel held 120,033,262 Ordinary shares, which represent 99.8% of the paid-up capital of the Company.

Note 32: Subsequent Events

1. On March 1, 2007, the Electricity Sector Law was amended (Amendment No. 5) outlining the structural change in the Company (see Note 1 above).

2. On January 31, 2007, the Company issued non-marketable debentures (partly linked and partly unlinked) with a total par value of approximately NIS 330 million and NIS 42 million, respectively to institutional organizations through a private placement in consideration of approximately NIS 375 million and NIS 48 million, respectively. The debentures vest over a period of some 11 years under the standard interest rates for the Company's capital raisings.

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above)

a. Statement of operations for the year ended December 31, 2006:

	Distribution	Transmission	Generation	Total
	NIS in millions			
Required revenues	3,405	1,376	13,290	18,071
Adjustment for segment revenues	(902)	(53)	367	(588)
Revenues from electricity	**2,503**	**1,323**	**13,657**	**17,483**
Other revenues	83	-	24	107
Total revenues	**2,586**	**1,323**	**13,681**	**17,590**
Cost for operating electricity system	1,360	711	11,372	13,443
Profit from operating electricity system	**1,226**	**612**	**2,309**	**4,147**
Sales and marketing expenses	763	-	-	763
Administrative and general expenses	287	107	372	766
Expenses from liabilities to pensioners, net	46	6	65	117
	1,096	**113**	**437**	**1,646**
Income from current operations	**130**	**499**	**1,872**	**2,501**
Financial expenses, net	735	409	1,032	2,176
Other expenses (income), net	5	-	(12)	(7)
Operating income (loss) before income taxes	**(610)**	**90**	**852**	**332**
Taxes on income	(162)	24	226	88
Income (loss) from current operations after taxes on income	**(448)**	**66**	**626**	**244**
Equity in the earnings of affiliates, net	-	-	9	9
Net income (loss)	**(448)**	**66**	**635**	**253**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

b. Details of the generation segment sites - statement of income for the year ended December 31, 2006:

	Orot Rabin	**Rutenberg**	**PEP and others**	**Total generation units**
		NIS in millions		
Required revenues	3,457	3,079	83	13,290
Adjustment for segment revenues	96	86	-	367
Revenues from electricity	**3,553**	**3,165**	**83**	**13,657**
Other revenues	6	6	-	24
Total revenues	**3,559**	**3,171**	**83**	**13,681**
Cost for operating electricity system	2,962	2,398	83	11,372
Profit from operating electricity system	**597**	**773**	**-**	**2,309**
Sales and marketing expenses	-	-	-	-
Administrative and general expenses	98	85	-	372
Expenses from liabilities to pensioners, net	19	16	-	65
	117	**101**	**-**	**437**
Income from current operations	480	672	-	1,872
Financial expenses, net	265	402	-	1,032
Other income, net	(3)	(3)	-	(12)
Operating income before income taxes	**218**	**273**	**-**	**852**
Taxes on income	58	73	-	226
Income from current operations after taxes on income	**160**	**200**	**-**	**626**
Equity in the earnings of affiliates, net	5	4	-	9
Net income	**165**	**204**	**-**	**635**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

b. Details of the generation segment sites - statement of income for the year ended December 31, 2006: (cont.)

	Gezer	Eshkol	Reading	Haifa
	NIS in millions			
Required revenues	811	576	1,663	961
Adjustment for segment revenues	23	16	46	27
Revenues from electricity	**834**	**592**	**1,709**	**988**
Other revenues	1	2	4	2
Total revenues	**835**	**594**	**1,713**	**990**
Cost for operating electricity system	666	523	1,461	901
Profit from operating electricity system	**169**	**71**	**252**	**89**
Sales and marketing expenses	-	-	-	-
Administrative and general expenses	19	28	56	33
Expenses from liabilities to pensioners, net	1	5	11	7
	20	**33**	**67**	**40**
Income from current operations	**149**	**38**	**185**	**49**
Financial expenses, net	86	15	95	15
Other income, net	(1)	-	(1)	(1)
Operating income before income taxes	**64**	**23**	**91**	**35**
Taxes on income	17	6	24	9
Income from current operations after taxes on income	**47**	**17**	**67**	**26**
Equity in the earnings of affiliates, net	-	-	-	-
Net income	**47**	**17**	**67**	**26**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

b. Details of the generation segment sites - statement of income for the year ended December 31, 2006: (cont.)

	Hagit	Alon Tavor	Ramat Hovav	Zafit	Other Gas turbines
			NIS in millions		
Required revenues	1,147	290	842	193	188
Adjustment for segment revenues	32	8	23	5	5
Revenues from electricity	**1,179**	**298**	**865**	**198**	**193**
Other revenues	1	-	1	-	1
Total revenues	**1,180**	**298**	**866**	**198**	**194**
Cost for operating electricity system	1,034	238	780	169	157
Profit from operating electricity system	**146**	**60**	**86**	**29**	**37**
Sales and marketing expenses	-	-	-	-	-
Administrative and general expenses	17	7	15	5	9
Expenses from liabilities to pensioners, net	2	1	2	-	1
	19	**8**	**17**	**5**	**10**
Income from current operations	**127**	**52**	**69**	**24**	**27**
Financial expenses, net	65	30	31	13	15
Other income, net	(2)	-	(1)	-	-
Operating income before income taxes	**64**	**22**	**39**	**11**	**12**
Taxes on income	17	6	10	3	3
Income from current operations after taxes on income	**47**	**16**	**29**	**8**	**9**
Equity in the earnings of affiliates, net	-	-	-	-	-
Net income	**47**	**16**	**29**	**8**	**9**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

c. Details of the distribution segment sites - statement of operations as of December 31, 2006

	Haifa District	Northern District	Total Distribution Segment
		NIS in millions	
Required revenues	418	682	3,405
Adjustment for segment revenues	(111)	(181)	(902)
Revenues from electricity	**307**	**501**	**2,503**
Other revenues	8	20	83
Total revenues	**315**	**521**	**2,586**
Cost for operating electricity system	168	281	1,360
Profit from operating electricity system	**147**	**240**	**1,226**
Sales and marketing expenses	91	139	763
Administrative and general expenses	43	67	287
Expenses from liabilities to pensioners, net	6	8	46
	140	**214**	**1,096**
Income from current operations	**7**	**26**	**130**
Financial expenses, net	85	147	735
Other expenses, net	1	1	5
Operating loss before income taxes	**(79)**	**(122)**	**(610)**
Taxes on income	(22)	(32)	(162)
Loss from current operations after taxes on income	**(57)**	**(90)**	**(448)**
Equity in the earnings of affiliates, net	-	-	-
Net loss	**(57)**	**(90)**	**(448)**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

c. Details of the distribution segment sites - statement of operations as of December 31, 2006 (cont.)

	Southern District	**Dan District**	**Jerusalem District**
		NIS in millions	
Required revenues	1,168	700	437
Adjustment for segment revenues	(309)	(185)	(116)
Revenues from electricity	**859**	**515**	**321**
Other revenues	32	14	9
Total revenues	**891**	**529**	**330**
Cost for operating electricity system	454	268	189
Profit from operating electricity system	**437**	**261**	**141**
Sales and marketing expenses	284	161	88
Administrative and general expenses	91	51	35
Expenses from liabilities to pensioners, net	17	9	6
	392	**221**	**129**
Income from current operations	**45**	**40**	**12**
Financial expenses, net	252	160	91
Other expenses, net	2	1	-
Operating loss before income taxes	**(209)**	**(121)**	**(79)**
Taxes on income	(55)	(32)	(21)
Loss from current operations after taxes on income	**(154)**	**(89)**	**(58)**
Equity in the earnings of affiliates, net	-	-	-
Net loss	**(154)**	**(89)**	**(58)**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

d. Balance sheet as of December 31, 2006

	Distribution	Transmission	Generation	Total
	NIS in millions			
Current assets	902	602	4,803	6,307
Long-term debts	830	119	2,322	3,271
Investments in investee companies	-	-	57	57
Fixed assets, net	15,462	13,462	29,040	57,964
Other assets, net	-	-	-	-
	17,194	**14,183**	**36,222**	**67,599**
Current liabilities	2,014	922	4,112	7,048
Long-term and very long-term liabilities, net	9,896	9,082	23,750	42,728
Deferred taxes, net	1,286	1,017	2,034	4,337
Shareholders' equity	3,998	3,162	6,326	13,486
	17,194	**14,183**	**36,222**	**67,599**

e. Details of the generation segment sites - balance sheet as of December 31, 2006

	Orot Rabin	Rutenberg	PEP and others	Total generation units
	NIS in millions			
Current assets	1,211	1,128	35	4,803
Long-term debts	475	285	1,022	2,322
Investments in investee companies	33	24	-	57
Fixed assets, net	5,967	9,138	556	29,040
Other assets, net	-	-	-	-
	7,686	**10,575**	**1,613**	**36,222**
Current liabilities	1,117	1,121	130	4,112
Long-term and very long-term liabilities, net	4,478	6,247	1,483	23,750
Deferred taxes, net	509	780	-	2,034
Shareholders' equity	1,582	2,427	-	6,326
	7,686	**10,575**	**1,613**	**36,222**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

e. Details of the generation segment sites - balance sheet as of December 31, 2006 (cont.)

	Gezer	Eshkol	Reading	Haifa
	NIS in millions			
Current assets	314	586	193	341
Long-term debts	18	198	98	121
Investments in investee companies	-	-	-	-
Fixed assets, net	3,627	2,169	363	1,581
Other assets, net	-	-	-	-
	3,959	**2,953**	**654**	**2,043**
Current liabilities	332	365	141	290
Long-term and very long-term liabilities, net	2,890	1,827	386	1,630
Deferred taxes, net	179	185	31	30
Shareholders' equity	558	576	96	93
	3,959	**2,953**	**654**	**2,043**

	Hagit	Alon Tavor	Ramat Hovav	Zafit	Other Gas turbines
	NIS in millions				
Current assets	432	114	303	79	67
Long-term debts	36	12	28	8	21
Investments in investee companies	-	-	-	-	-
Fixed assets, net	2,662	1,324	693	639	321
Other assets, net	-	-	-	-	-
	3,130	**1,450**	**1,024**	**726**	**409**
Current liabilities	273	124	110	51	58
Long-term and very long-term liabilities, net	2,341	1,090	671	467	240
Deferred taxes, net	126	57	59	51	27
Shareholders' equity	390	179	184	157	84
	3,130	**1,450**	**1,024**	**726**	**409**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

f. Details of the distribution segment sites - balance sheet as of December 31, 2006

	Haifa District	**Northern District**	**Total Distribution Segment**
	NIS in millions		
Current assets	105	180	902
Long-term debts	104	159	830
Investments in investee companies	-	-	-
Fixed assets, net	1,737	3,136	15,462
Other assets, net	-	-	-
	1,946	**3,475**	**17,194**
Current liabilities	238	393	2,014
Long-term and very long-term liabilities, net	1,113	2,025	9,896
Deferred taxes, net	145	257	1,286
Shareholders' equity	450	800	3,998
	1,946	**3,475**	**17,194**

	Southern District	**Dan District**	**Jerusalem District**
	NIS in millions		
Current assets	316	186	115
Long-term debts	304	161	102
Investments in investee companies	-	-	-
Fixed assets, net	5,318	3,335	1,936
Other assets, net	-	-	-
	5,938	**3,682**	**2,153**
Current liabilities	706	441	236
Long-term and very long-term liabilities, net	3,416	2,090	1,252
Deferred taxes, net	442	280	162
Shareholders' equity	1,374	871	503
	5,938	**3,682**	**2,153**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

g. Statement of income for the year ended December 31, 2005

	Distribution	Transmission	Generation	Total
	NIS in millions			
Required revenues	3,521	996	12,732	17,249
Adjustment for segment revenues	(590)	(191)	202	(579)
Revenues from electricity	**2,931**	**805**	**12,934**	**16,670**
Other revenues	73	-	5	78
Total revenues	**3,004**	**805**	**12,939**	**16,748**
Cost for operating electricity system	1,442	482	10,835*	12,759*
Profit from operating electricity system	**1,562**	**323**	**2,104**	**3,989**
Sales and marketing expenses	720*	-	-	720*
Administrative and general expenses	225*	89	324*	638*
Expenses from liabilities to pensioners, net	45	4	57	106
	990	**93**	**381**	**1,464**
Income from current operations	**572**	**230**	**1,723**	**2,525**
Financial expenses, net	726	273	914	1,913
Other expenses, net	2	4	2	8
Operating income (loss) before income taxes	**(156)**	**(47)**	**807**	**604**
Taxes on income	(362)	(132)	(179)	(673)
Income from current operations after taxes on income	**206**	**85**	**986**	**1,277**
Equity in the earnings of affiliates, net	-	-	7	7
Net income	**206**	**85**	**993**	**1,284**

* Reclassified

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

h. Details of the generation segment sites - statement of income for the year ended December 31, 2005

	Orot Rabin	Rutenberg	PEP and others	Total generation units
	NIS in millions			
Required revenues	3,612	3,316	73	12,732
Adjustment for segment revenues	58	53	-	202
Revenues from electricity	**3,670**	**3,369**	**73**	**12,934**
Other revenues	2	-	-	5
Total revenues	**3,672**	**3,369**	**73**	**12,939**
Cost for operating electricity system	3,086	2,610	73	10,835
Profit from operating electricity system	**586**	**759**	**-**	**2,104**
Administrative and general expenses	92	71	-	324
Expenses from liabilities to pensioners, net	19	12	-	57
	111	**83**	**-**	**381**
Income from current operations	**475**	**676**	**-**	**1,723**
Financial expenses, net	252	376	-	914
Other expenses, net	-	4	-	2
Operating income before income taxes	**223**	**296**	**-**	**807**
Taxes on income	(44)	(76)	-	(179)
Income from current operations after income taxes on income	**267**	**372**	**-**	**986**
Equity in the earnings of affiliates, net	4	3	-	7
Net income	**271**	**375**	**-**	**993**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

h. Details of the generation segment sites - statement of income for the year ended December 31, 2005 (cont.)

	Gezer	Eshkol	Reading	Haifa
	NIS in millions			
Required revenues	645	1,509	731	700
Adjustment for segment revenues	10	24	12	11
Revenues from electricity	**655**	**1,533**	**743**	**711**
Other revenues	1	1	-	1
Total revenues	**656**	**1,534**	**743**	**712**
Cost for operating electricity system	538	1,332	676	646
Profit from operating electricity system	**118**	**202**	**67**	**66**
Administrative and general expenses	18	47	27	30
Expenses from liabilities to pensioners, net	1	9	5	6
	19	**56**	**32**	**36**
Income from current operations	**99**	**146**	**35**	**30**
Financial expenses, net	52	73	14	11
Other income, net	-	(1)	(1)	(1)
Operating income before income taxes	**47**	**74**	**22**	**20**
Taxes on income	(16)	(17)	-	(1)
Income from current operations after taxes on income	**63**	**91**	**22**	**21**
Equity in the earnings of affiliates, net	-	-	-	-
Net income	**63**	**91**	**22**	**21**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

h. Details of the generation segment sites - statement of income for the year ended December 31, 2005 (cont.)

	Hagit	Alon Tavor	Ramat Hovav	Zafit	Other Gas turbines
			NIS in millions		
Required revenues	879	270	629	189	179
Adjustment for segment revenues	14	4	10	3	3
Revenues from electricity	**893**	**274**	**639**	**192**	**182**
Other revenues	-	-	-	-	-
Total revenues	**893**	**274**	**639**	**192**	**182**
Cost for operating electricity system	765	220	570	173	146
Profit from operating electricity system	**128**	**54**	**69**	**19**	**36**
Sales and marketing expenses	-	-	-	-	-
Administrative and general expenses	14	5	9	3	8
Expenses from liabilities to pensioners, net	2	1	1	-	1
	16	**6**	**10**	**3**	**9**
Income from current operations	**112**	**48**	**59**	**16**	**27**
Financial expenses, net	59	27	29	7	14
Other expenses, net	1	-	-	-	-
Operating income before income taxes	**52**	**21**	**30**	**9**	**13**
Taxes on income	(11)	(6)	(4)	(1)	(3)
Income from current operations after taxes on income	**63**	**27**	**34**	**10**	**16**
Equity in the earnings of affiliates, net	-	-	-	-	-
Net income	**63**	**27**	**34**	**10**	**16**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

i. Details of the distribution segment sites - statement of income for the year ended December 31, 2005

	Haifa District	**Northern District**	**Total Distribution Segment**
		NIS in millions	
Required revenues	423	691	3,521
Adjustment for segment revenues	(71)	(116)	(590)
Revenues from electricity	**352**	**575**	**2,931**
Other revenues	8	19	73
Total revenues	**360**	**594**	**3,004**
Cost for operating electricity system	176	292	1,442
Profit from operating electricity system	**184**	**302**	**1,562**
Sales and marketing expenses	85	135	720
Administrative and general expenses	30	43	225
Expenses from liabilities to pensioners, net	6	9	45
	121	**187**	**990**
Income from current operations	**63**	**115**	**572**
Financial expenses, net	84	145	726
Other expenses, net	-	-	2
Operating loss before income taxes	**(21)**	**(30)**	**(156)**
Taxes on income	(43)	(71)	(362)
Income from current operations after taxes on income	**22**	**41**	**206**
Equity in the earnings of affiliates, net	-	-	-
Net income	**22**	**41**	**206**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

i. Details of the distribution segment sites - statement of income for the year ended December 31, 2005 (cont.)

	Southern District	**Dan District**	**Jerusalem District**
		NIS in millions	
Required revenues	1,225	738	444
Adjustment for segment revenues	(205)	(124)	(74)
Revenues from electricity	**1,020**	**614**	**370**
Other revenues	27	12	7
Total revenues	**1,047**	**626**	**377**
Cost for operating electricity system	497	287	190
Profit from operating electricity system	**550**	**339**	**187**
Sales and marketing expenses	262	155	83
Administrative and general expenses	81	41	30
Income from liabilities to pensioners, net	16	9	5
	359	**205**	**118**
Income from current operations	**191**	**134**	**69**
Financial expenses, net	247	161	89
Other expenses, net	1	1	-
Operating loss before income taxes	**(57)**	**(28)**	**(20)**
Taxes on income	(125)	(78)	(45)
Income from current operations after taxes on income	**68**	**50**	**25**
Equity in the earnings of affiliates, net	-	-	-
Net income	**68**	**50**	**25**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

j. Statement of income for the year ended December 31, 2004

	Distribution	**Transmission**	**Generation**	**Total**
	NIS in millions			
Required revenues	3,451	977	10,266	14,694
Adjustment for segment revenues	(498)	(188)	826	140
Revenues from electricity	**2,953**	**789**	**11,092**	**14,834**
Other revenues	67	-	24	91
Total revenues	**3,020**	**789**	**11,116**	**14,925**
Cost for operating electricity system	1,435	470	8,466*	10,371*
Profit from operating electricity system	**1,585**	**319**	**2,650**	**4,554**
Sales and marketing expenses	675*	-	-	675*
Administrative and general expenses	227*	85	309*	621*
Expenses from liabilities to pensioners, net	35	3	44	82
	937	**88**	**353**	**1,378**
Income from current operations	**648**	**231**	**2,297**	**3,176**
Financial expenses, net	742	283	956	1,981
Other expenses, net	43	4	53	100
Operating income (loss) before income taxes	**(137)**	**(56)**	**1,288**	**1,095**
Effect of the change in the tax rate on the deferred taxes	(358)	(135)	(450)	(943)
Taxes on income	(43)	(17)	400	340
	(401)	**(152)**	**(50)**	**(603)**
Income from current operations after taxes on income	**264**	**96**	**1,338**	**1,698**
Equity in the earnings of affiliates, net	-	-	3	3
Income before extraordinary items	**264**	**96**	**1,341**	**1,701**

* Reclassified

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

k. Details of the generation segment sites - statement of income for the year ended December 31, 2004

	Orot Rabin	Rutenberg	PEP and others	Total generation units
		NIS in millions		
Required revenues	3,195	3,109	55	10,266
Adjustment for segment revenues	257	250	-	826
Revenues from electricity	**3,452**	**3,359**	**55**	**11,092**
Other revenues	8	6	-	24
Total revenues	**3,460**	**3,365**	**55**	**11,116**
Cost for operating electricity system	2,649	2,374	55	8,466
Profit from operating electricity system	**811**	**991**	**-**	**2,650**
Administrative and general expenses	91	74	-	309
Expenses from liabilities to pensioners, net	14	11	-	44
	105	**85**	**-**	**353**
Income from current operations	**706**	**906**	**-**	**2,297**
Financial expenses, net	280	409	-	956
Other expenses, net	17	12	-	53
Operating income before income taxes	**409**	**485**	**-**	**1,288**
Effect of the change in the tax rate on the deferred taxes	(129)	(192)	-	(450)
Other taxes on income	126	150	-	400
	(3)	**(42)**	**-**	**(50)**
Income from current operations after income taxes on income	**412**	**527**	**-**	**1,338**
Equity in the earnings of affiliates, net	2	1	-	3
Income before extraordinary items	**414**	**528**	**-**	**1,341**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

k. Details of the generation segment sites - statement of income for the year ended December 31, 2004 (cont.)

	Gezer	Eshkol	Reading	Haifa
	NIS in millions			
Required revenues	227	1,321	574	535
Adjustment for segment revenues	18	110	47	44
Revenues from electricity	**245**	**1,431**	**621**	**579**
Other revenues	-	4	2	2
Total revenues	**245**	**1,435**	**623**	**581**
Cost for operating electricity system	151	1,214	531	502
Profit from operating electricity system	**94**	**221**	**92**	**79**
Administrative and general expenses	6	45	25	28
Expenses from liabilities to pensioners, net	-	7	4	5
	6	**52**	**29**	**33**
Income from current operations	**88**	**169**	**63**	**46**
Financial expenses, net	44	63	14	9
Other expenses, net	-	9	5	6
Operating income before income taxes	**44**	**97**	**44**	**31**
Effect of the change in the tax rate on the deferred taxes	(20)	(30)	(7)	(4)
Other taxes on income	14	30	14	10
	(6)	**-**	**7**	**6**
Income from current operations after taxes on income	**50**	**97**	**37**	**25**
Equity in the earnings of affiliates, net	-	-	-	-
Income before extraordinary items	**50**	**97**	**37**	**25**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

k. Details of the generation segment sites - statement of income for the year ended December 31, 2004 (cont.)

	Hagit	Alon Tavor	Ramat Hovav	Zafit	Other Gas turbines
			NIS in millions		
Required revenues	587	124	345	52	142
Adjustment for segment revenues	47	10	28	4	11
Revenues from electricity	**634**	**134**	**373**	**56**	**153**
Other revenues	1	-	-	-	1
Total revenues	**635**	**134**	**373**	**56**	**154**
Cost for operating electricity system	472	90	286	36	106
Profit from operating electricity system	**163**	**44**	**87**	**20**	**48**
Administrative and general expenses	13	4	7	3	13
Expenses from liabilities to pensioners, net	1	-	1	-	1
	14	**4**	**8**	**3**	**14**
Income from current operations	**149**	**40**	**79**	**17**	**34**
Financial expenses, net	63	19	32	8	15
Other expenses, net	2	-	1	-	1
Operating income before income taxes	**84**	**21**	**46**	**9**	**18**
Effect of the change in the tax rate on the deferred taxes	(29)	(13)	(15)	(4)	(7)
Other taxes on income	26	7	14	3	6
	(3)	**(6)**	**(1)**	**(1)**	**(1)**
Income from current operations after taxes on income	**87**	**27**	**47**	**10**	**19**
Equity in the earnings of affiliates, net	-	-	-	-	-
Income before extraordinary items	**87**	**27**	**47**	**10**	**19**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

I. Details of the distribution segment sites - statement of income for the year ended December 31, 2004

	Haifa District	Northern District	Total Distribution Segment
		NIS in millions	
Required revenues	399	664	3,451
Adjustment for segment revenues	(58)	(96)	(498)
Revenues from electricity	**341**	**568**	**2,953**
Other revenues	8	17	67
Total revenues	**349**	**585**	**3,020**
Cost for operating electricity system	160	291	1,435
Profit from operating electricity system	**189**	**294**	**1,585**
Sales and marketing expenses	79	108	675
Administrative and general expenses	28	46	227
Expenses from liabilities to pensioners, net	5	7	35
	112	**161**	**937**
Income from current operations	**77**	**133**	**648**
Financial expenses, net	86	148	742
Other expenses, net	6	8	43
Operating loss before income taxes	**(15)**	**(23)**	**(137)**
Effect of the change in the tax rate on the deferred taxes	(41)	(72)	(358)
Other taxes on income	(5)	(7)	(43)
	(46)	**(79)**	**(401)**
Income from current operations after taxes on income	**31**	**56**	**264**
Equity in the earnings of affiliates, net	-	-	-
Income before extraordinary items	**31**	**56**	**264**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

I. Details of the distribution segment sites - statement of income for the year ended December 31, 2004 (cont.)

	Southern District	Dan District	Jerusalem District
		NIS in millions	
Required revenues	1,193	741	454
Adjustment for segment revenues	(172)	(107)	(65)
Revenues from electricity	**1,021**	**634**	**389**
Other revenues	24	12	6
Total revenues	**1,045**	**646**	**395**
Cost for operating electricity system	492	287	205
Profit from operating electricity system	**553**	**359**	**190**
Sales and marketing expenses	251	156	81
Administrative and general expenses	80	43	30
Income from liabilities to pensioners, net	12	7	4
	343	**206**	**115**
Income from current operations	**210**	**153**	**75**
Financial expenses, net	249	167	92
Other expenses, net	15	9	5
Operating loss before income taxes	**(54)**	**(23)**	**(22)**
Effect of the change in the tax rate on the deferred taxes	(121)	(80)	(44)
Other taxes on income	(16)	(8)	(7)
	(137)	**(88)**	**(51)**
Income from current operations after taxes on income	**83**	**65**	**29**
Equity in the earnings of affiliates, net	-	-	-
Income before extraordinary items	**83**	**65**	**29**

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

m. General

1. As previously stated, based on section 33.b. of the Government Companies Law, and in accordance with the provisions of the Companies Authority circular dated March 2, 2004 (see Note 1.c above), the Company is required to provide disclosure in the form of a Note to the primary financial statements. It will include statements of income, condensed balance sheets related to the various activities segments and details of assumptions and the principal details that were used in their preparation. Disclosure will also be provided of the financial targets, including targets to meet normative recognized costs in the various activities segments that were (or will be) determined by the Electricity Authority, and the differences between them and the effective costs, as stated in the Companies Authority's circular on financial statements (see Note 1 above).

2. The Company's activities are composed of three principal segments:
a. Generation - activities of the power plants producing electricity.
b. Transmission - the transmission and transformation system for high-voltage electricity and over long distances.
c. Distribution - the electricity grid and the transformer stations system that brings electricity to the end consumer (except for a small number of customers who purchase high-voltage electricity and are directly connected to the transmission system), as well as the customer service and collection system of the Company. These segments are called the electricity chain ("the electricity chain").

3. The rate basis that came into force in July 2002 initially included various rates for four segments in the electricity chain: generation, transmission, distribution and supply. The different rates are intended to enable the independent producers and customers to trade in electricity through a partial usage of the Company's system.

4. The Company manages one accounting system that includes all of the activities of the electricity chain.
The internal controls principles that exist for everything concerning the internal trade between the activities of the electricity web are not compatible those required for separate audited financial statements.

5. Under the basic rate that was in effect until June 30, 2006, 80.7% of the expenses relating to the substations were diverted from the transmission segment to the distribution segment and expenses relating to connections in the transmission segment were diverted to the generation and distribution segments. As of July 1, 2006, the Electricity Authority reallocated the costs recognized in respect of the segment rates without fundamentally changing the recognized costs in respect of the entire Company. The reallocation was carried out while adhering to the principle of ownership over the properties in relation to use of properties. In view of the decision of the Electricity Authority to reallocate costs as above, the Company made a corresponding adjustment of the allocation of costs and property. The Company also recorded "usage fees" based on the above principles between the segments.

n. The principles used in attributing the statements of income are as follows

1. General
a) The principles that the Electricity Authority used for determining the rate for the aforesaid activities segments, will be implemented in these statements of income.
b) Since the Company is one legal entity, in effect complete separate entries are not recorded for electricity chain's segments. The attribution of the expenses and income of the statement of income to the level of the segments is performed as applicable, as will be described below.
The statements of income as they are presented in this Note do not necessarily reflect the results of operations of the various segments if they had been managed as separate economic entities, as implied in generally accepted accounting principles.

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

n. The principles used in attributing the statements of income are as follows (cont.)

2. Below are the principles for attributing the income between the various segments

a) Revenues from the sale of electricity

The gross revenues for the segment are calculated based on the rate for the segment published by the Electricity Authority, multiplied by the amount sold (kWh) for that segment.

1) Amount sold per segment

The amount sold in each segment is calculated based on data of the amount of sales to the end customers according to the type of the customer (amount measured in a systematic way in each segment), in addition, of the amount that is purchased from independent producers (known amount for each segment) and their adjustment to the generation data, net (continuous measured amount), by adding the amount of normative loss for each segment and standardizing it according to the effective amount of loss.

Adjustment of the amounts between the segments is required since there is a gap between the amount sold and the amount generated and purchased. The gap derives from losses in the systems that are primarily caused by weather conditions, system load and the distance it is transmitted.

Since there is no continuous quantitative measurement of KWhs transferred between the transmission segments to the distribution segment, it is not possible to estimate the scope of losses in each segment. For that purpose, they are aided by normative loss coefficients that the Electricity Authority determined for calculating the amount of sales between the segments.

The total losses in the system are added to segments according the ratio of normative losses that were determined by the Electricity Authority.

2) Rate for the segment

The electricity rates that were determined by the Electricity Authority are divided into two main categories:

(a) Rates according to load and time ("LTR") - rate that varies according to the season of the year and the time of day, where it is split to each of the segments of the electricity chain (a total of nine rates at the segment level).

(b) A uniform rate according to type of consumer that is supposed to reflect over an entire year, the LTR rate according to the expected level of demand by those paying that same rate during the various seasons and time of day (a total of five types of uniform rates at the segment level).

The uniform rate, in accordance with the various types of consumers, is calculated for the various segments, in accordance with the model that was used by the Electricity Authority in determining the rates for the Company.

3) Calculation of the income for the electricity chain segments:

The income for the segment is calculated by multiplying the amount of sales calculated for each segment by the various types of consumers at the appropriate rates.

The difference, which derives from the Company's effective income and the obtained calculated income, is distributed among the segments according to the amount of their calculated income.

4) In addition, and in view of the matter discussed in m.5 above, as of July 1, 2006, revenues from usage fees are calculated in respect of substations and connections.

These revenues are collected at the generation and distribution segment rates and carried to the transmission segment in respect of the usage fees for the segment's properties. Revenues from usage fees in substations are calculated at a rate per kWh multiplied by the quantity transmitted in the segment. Revenues from usage fees in respect of connections are calculated at a rate per kWh multiplied by the installed transformation capacity.

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

n. The principles used in attributing the statements of income are as follows (cont.)

2. Below are the principles for attributing the income between the various segments (cont.)

b. Collection of regulatory assets and income in respect to the pension component - are added or subtracted, based on their inclusion in the rate, since their collection does not constitute income in the statement of income.

c. The various income - are attributed to the appropriate segment, according to its nature.

3. Below are the principles for attributing the expenses to the various segments

The specifically identifiable expenses are charged directly to the appropriate items. Certain indirect expenses are recorded for those items according to distribution indices that, in the Company's assessment, constitute a reasonable assessment for the attribution of those expenses.

a) Cost for operating the electricity system - reflects in the Company's financial statements the operating expenses in the generation, transmission and distribution segments.

b) Selling and marketing expenses - include the expenses for services to consumers that are attributed to the distribution segment.

c) General and administrative expenses (includes salary, depreciation and other expenses)

The basis for attributing the general and administrative expenses items to segments was determined in accordance with the nature of the activities of the Company's various units, whose costs are attributed to general and administrative expenses; see the following details:

1) The general administrative expenses, the accounting and economic division and amortization - are presented according to the ratio of the distribution of the operating expenses in the electricity chain during the reported period.

2) The expenses for the human resources department are presented according to the ratio of the distribution of the salary expenses to the electricity chain during the reported period.

3) Doubtful accounts and bad debts - are presented according to the ratio of the gross revenues from electricity sales of the electricity chain during the reported period.

4) Communications, electronics and quality control, planning and technological development expenses - are presented according to the activities of the relevant unit.

d) Expenses (income) from liabilities, net, to pensioners -These expenses (income) are presented according to the ratio for allocating the salary expenses to the electricity chain during the reported period.

e) Financial expenses (income), net -Primarily derive from the operated fixed assets and, therefore, they were attributed according to the average ratio of the operated fixed assets, net in the electricity chain during the reported period.

f) Other expenses (income), net - were attributed by their nature to the electricity chain.

4. Taxes on income - deferred

- The deferred taxes are presented according to the ratio of the income before tax for all of the various segments, out of the total pre-tax income of all of the segments.
- Income from taxes - in respect to the changes in the tax rate for the deferred taxes are attributed to the various segments according to the ratio of the operated fixed assets, net.

5. Equity in the earnings of affiliated companies

This income derives from the earnings of a subsidiary - the National Coal Supply Company Ltd. and, therefore, it was attributed entirely to the generation segment.

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

o. The principles used in attributing the aforesaid balance sheet items are as follows

1. The Company is one legal entity and, in effect, the balance sheet balances are not separated according to the Company's activities segments in its books (except for direct fixed assets). Therefore, the Company is resplitting the balance sheet balances for purpose of this Note, at every financial statement date, based on allocation keys, as described below.

2. The balance sheets as they are presented in this Note do not necessarily reflect the financial position of the various segments, if they would have been managed as a separate economic entity, as implied in generally accepted accounting principles.

3. Below are the principles for attributing the balance sheet balances to the various segments:

a. Working capital items:
The working capital items were attributed to the segments in accordance with those principles that the Electricity Authority used in determining the electricity rates (principally for the purpose of determining the coverage of the working capital's financial expenses) where the principal allocation keys are:
Fuel inventories and balance for fuel suppliers - were fully attributed to the generation segment. The trade receivables balance allocated according to the ratio for distributing revenues. Trade payables and other items were allocated primarily according to the ratio of the operating expenses and salary for the segments.

b. Fixed assets:
Fixed assets that are specifically identifiable are included in the appropriate segment. Joint assets (about 4% of the entire assets) were distributed according to distribution keys that, in management's opinion, constitute a reasonable estimate for attributing these assets.

c. Shareholders' equity and deferred taxes:
Shareholders' equity and deferred taxes are allocated according to the ratio of the active fixed assets, net.

d. Loans and debentures:
The loans and debentures were split in accordance with the other balance sheet items, and principally according to the distribution ratio of fixed assets to segments, in accordance with the nature of the financing for the Company's assets pursuant to the rate principles.

e. The remaining balance sheet items were distributed according to distribution keys that, in the Company's estimation, constitute a reasonable estimate for attributing these items.

p. Information regarding the attribution of the statement of income and balance sheet according to 18 reporting units

1. General

In addition to the aforesaid in section m.1 above, the Company was required to provide disclosure in the form of a Note that is to include statements of operations and a balance sheet, in reference to 18 activities that are included in the three electricity chain segments, as follows:

Generation segment	11 generation sites: Rutenberg, Orot Rabin, Haifa, Reading, Eshkol, Gezer, Hagit, Alon Tavor, Ramat Hovav, Zafit and the other gas turbines. In addition, it also reports on activities for acquiring electricity from independent producers.
Transmission segment	The electricity transmission and transformation system.
Distribution segment	The Company's five districts: Northern, Haifa, Jerusalem, Dan, Southern.

Below, the 18 operations segments will be called: "reporting units".

Note 33: Information Regarding the Attribution of Statement of Income and the Balance Sheet According to Activities Segments: Generation, Transmission and Distribution (see note 1.c above) (cont.)

p. Information regarding the attribution of the statement of income and balance sheet according to 18 reporting units (cont.)

2. Below are the primary principles for attributing the income

The income at the level of the reporting unit is calculated by stages since presently there is no electricity rate at the reporting unit level, and the Authority's current rates, at the level of the electricity chain's segments, do not allow for their attribution to a level that is lower than the segment level.

The income is calculated based on the following principles:

a) Calculation of the income from electricity at the level of the electricity chain segments, which is based on the electricity rates and agrees with the total of all revenues from electricity at the total Company level.

b) Determination of the required revenues at the reporting unit level for each reporting period.
Required income - cover for the effective costs during the reported period (operating costs including fuel and depreciation) neutralized by the various other income and expenses, and with the addition of normative financing costs and the normative rate of return on capital.
The required revenues are constructed based on the principal elements of the principles and regulations the Electricity Authority used in determining the electricity rate for the various segments.

c) The difference between the total required revenues for the reporting unit in the segment and the revenues of the appropriate segment was distributed among the reporting units according to the ratio of required revenue of the segment.

d) The revenues from electricity at the reporting unit level were not intended in order to estimate the revenues that will be obtained from the electricity if and when electricity rates are determined at the reporting unit level and, therefore, statements of income according to 18 reporting units do not necessarily reflect the results of their operations if they were managed as separate economic entities, as implied in generally accepted accounting principles.

3. The principles for the attribution of expenses are as follows:

The principles for attributing the expenses at the level of the reporting units agree with the principles that were applied in the reporting according to the three electricity chain segments (see section n. above).

Joint expenses for a segment (such as management of the segment) were attributed to the reporting units, generally on the basis of the direct operating costs for each reporting unit.

Other expenses that are not allocated in the Company's books of account (such as general and administrative and financial) were attributed to the reporting units in accordance with the burdening bases use in the reporting according to the electricity chain segments.

4. Equity in the earnings of affiliated companies

The income attributed to the reporting units included in the generation segment according to the coal consumption ratio.

5. Principles that were used in attributing the balance sheet items according to 18 reporting units

According to what is stated in section o. above, the Company is one legal entity and, in effect, the balance sheet balances are not segregated in the Company's books according to the segments of the Company's activities. Therefore, the Company reattributes the balance sheet balances for the purpose of this Note for each reported period based on allocation keys, as described above in section o., while providing additional details to the 18 reporting units.

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